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THESIS

WHEN SHOULD BUREAU OF MEDICINE AND
SURGERY HOSPITALS MAKE OR BUY SERVICES?

by

Kirstina D. Shore

March 1997

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**WHEN SHOULD BUREAU OF MEDICINE AND SURGERY
HOSPITALS MAKE OR BUY SERVICES?**

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Lieutenant, United States Navy
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Submitted in partial fulfillment
of the requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

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ABSTRACT

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I. INTRODUCTION

A. THE CHANGING ENVIRONMENT

The international, national, and military environments have undergone rapid change in the past several years. This has generated changes in the Department of Defense (DoD) mission as well as the way the DoD achieves its mission.

Budget deficit reduction efforts, the end of the Cold-war, the drawdown of military and civilian personnel, reduced infrastructure from the Base Re-Alignment and Closure (BRAC), and decreased level of defense spending (in real dollars) have renewed DoD interest in implementing more efficient and cost-effective business practices. In an attempt to "do more with less," the DoD is increasing the use of make-or-buy analysis as a tool to efficiently and cost effectively accomplish its changing mission.

Make-or-buy analysis is not a new concept to the DoD or the federal government. In fact, Office Of Management and Budget (OMB) Circular A-76 and OPNAVINST 4860.7B have been in circulation since 4 August 1983 and 18 March 1986, respectively, with previous versions dating back to 1955. Both documents require that the government not compete with the private sector and encourage the use of commercial sources to provide the goods and services that the government needs. Compliance with the OMB Circular, however, has historically been under-enforced due to the lengthy and time consuming cost analysis requirements. Although recent changes have been made to the Supplement of the OMB Circular to encourage expanded use of contracting for commercial activities, more incentives are needed to make the effort

worthwhile for commands that comply with this policy. Nevertheless, decision makers throughout DoD are now viewing contracting as an opportunity to more cost effectively manage limited resources. This in turn has led to the increased use of make-or-buy analysis to discern whether making or buying a service will result in the best use of available resources.

At the health care industry level, both the public and private health care systems are undergoing reform. Like their private sector counterparts, Military Treatment Facility (MTF) Commanders are being deluged with policy changes that have been implemented to reduce, or at least control, health care costs and increase efficiency.

To address the changing role and mission of the military health care system that currently provides health care predominantly in-house, the Office of the Assistant Secretary for Health Affairs (OASD-HA) has revised its mission statement to accommodate the dynamic business climate and lead MTFs into the 21st century. The objectives of the mission statement are to:

- provide quality health care services before and during military operations, and to Active Duty Members, their families, and others who are entitled to DoD health care;
- be ready for joint operations as the dynamic global environment requires;
- provide quality cost-effective health benefits, develop military and civilian leaders who excel in a changing world climate; and
- be innovative and apply new technology.¹

¹Office of the Assistant Secretary of Defense (Health Affairs), "MHSS Strategic Planning," <http://hawww.ha.osd.mil:80/ppc/strat_ov.html> 29 January 1996: 1-2.

Initiatives implemented to achieve this mission include managed care (TRICARE), capitation, and regionalization. In addition to conducting make-or-buy analysis to comply with OMB Circular A-76 at the MTF level, the OASD (HA) is promoting the use of make-or-buy analysis as a management tool for making managed care (TRICARE) resource management decisions. Whether MTF Commanders are considering providing services or procedures in-house or through contracting (i.e., outsourcing) to support OMB Circular A-76 or the mission of OASD (HA), make-or-buy analysis is a management tool that MTF decision makers can use as a method to make informed resource utilization decisions.

The provision of a service in-house or through contracting is the result of a decision process. This decision process uses a "make-or-buy" analysis as a tool to evaluate the relevant quantitative and qualitative data evaluated when making the decision to provide the service in-house or through contracting.

B. AREA OF RESEARCH AND RESEARCH QUESTIONS

This thesis will focus on data relevant for Bureau of Medicine and Surgery (BUMED) hospitals to determine when they should make or buy services.

1. Primary Question

The primary question addressed in this thesis is: When Should BUMED Hospitals Make or Buy Services?

2. Secondary Questions

In answering the primary question, the following secondary questions will be addressed:

- What criteria should be used to evaluate the make-or-buy decision?

- What variables should be considered to form the make-or-buy decision?
- Which services have been the subject of make-or-buy analysis?
- Which services are planned for future make-or-buy analysis?
- What data have San Diego Naval Medical Center and a contractor used in make-or-buy analyses?

C. SCOPE

This thesis will primarily focus on one MTF within the BUMED health care system, Naval Medical Center San Diego, located at San Diego, California and will:

- describe the issues surrounding the make-or-buy decision, define outsourcing, identify criteria that should be used to evaluate a make-or-buy decision, identify the variables that should be considered to form the make-or-buy decision, discuss why outsourcing is used, summarize the advantages and disadvantages of outsourcing, and list alternatives to outsourcing;
- demonstrate the criteria, variables, advantages, and disadvantages that Naval Medical Center San Diego and a contractor used in make-or-buy analyses, discuss lessons learned;
- outline characteristics of the make-or-buy analyses conducted by Naval Medical Center San Diego and a contractor, apply the make-or-buy process to potential outsourcing initiatives at other MTFs, discuss lessons learned from both the public and private sectors; and
- recommend when MTFs should make or buy services.

This thesis will focus primarily on the quantitative and qualitative costs relevant in making or buying one specific service, food service. Time does not permit review of the costs relevant across all make-or-buy decision alternatives. The reader should be aware that costs relevant to one make-or-buy analysis may be more or less relevant

in another make-or-buy analysis. Further research in this area would be of value to the OASD (HA) and BUMED as more make-or-buy analysis opportunities arise.

D. METHODOLOGY

Archival, opinion, and survey research strategies were used. First, policy, professional, industry, and academic literature was reviewed to discern what outsourcing is, why outsourcing is used, and what the advantages and disadvantages are of outsourcing. Federal government, DoD, and Department of the Navy (DoN) research reports, professional journals, public and private industry magazines, and academic literature were reviewed to obtain an insight into professional, industry, and scholastic thought on the make-or-buy decision process.

Secondly, interviews were conducted with key personnel at the: 1) Bureau of Medicine and Surgery, Washington D.C., 2) Naval Medical Center, San Diego, California, 3) Community Hospital of the Monterey Peninsula (CHOMP), Monterey, California, 4) Kaiser Permanente, Oakland, California, 5) Naval Hospital, Camp Pendleton, California, and 6) National Naval Medical Center, Bethesda, Maryland. The purpose of the interviews was to gain knowledge from decision makers about the criteria, variables, and data used in the make-or-buy decision process. Interviews were also conducted to identify lessons learned from the make-or-buy decision process.

E. BENEFITS OF RESEARCH

This thesis will benefit the decision makers within the BUMED health care community. Specifically, this thesis is intended to provide

Commanding Officers and Executive Officers with the necessary management tools to facilitate the make-or-buy decision process at the MTF level.

This thesis will report how an MTF uses make-or-buy analysis in an attempt to comply with evolving DoD and BUMED initiatives to improve the Navy and Marine Corps health care system. Although the make-or-buy analysis may be conducted differently within and across MTFs, various practices which are observed as part of the Naval Medical Center San Diego case study may assist other MTFs throughout BUMED to improve various aspects of their make-or-buy analyses. Issues discussed and recommendations that are made may help decision makers in arriving at a more informed decision either to contract out or maintain services in-house.

F. ORGANIZATION OF RESEARCH

This section briefly describes the chapter content of the remainder of the thesis.

Chapter II (Issues Related Make-or-Buy Analysis): Chapter II begins by describing the changes in the global, national, and DoD environment which have inspired the renewed focus on make-or-buy analysis as a management tool. Outsourcing is defined and criteria that should be used to evaluate the make-or-buy decision are identified. Variables that should be used to form the make-or-buy decision are also identified. This is followed by a discussion of why outsourcing is used. Advantages and disadvantages of outsourcing are then observed. A list of alternatives to outsourcing concludes this chapter.

Chapter III (What Data Have Been Used in Make-or-Buy Analyses?): This chapter discusses criteria, variables, and data that Naval Medical

Center San Diego and a contractor used in make-or-buy analyses, the criteria used, and the variables assessed in making the decision. This chapter will describe the quantitative and qualitative data reviewed to make the decision to provide a service in-house or through outsourcing.

Chapter IV (What Are the Characteristics of Make-or-Buy Analysis?): The data presented in Chapter III are discussed and applied to potential make-or-buy analyses at other MTFs. Chapter IV concludes with a description of lessons learned from both the public and private sectors.

Chapter V (When Should BUMED Hospitals Make or Buy Services?). In this last chapter, conclusions will be drawn from the research to determine when MTFs should contract out or retain services in-house. Critical criteria to be used in the make-or-buy decision and the key variables to be assessed will be identified. The contingent weighting of criteria, critical to the make-or-buy decision will be presented.

Recommendations are made to suggest when BUMED hospitals should make or buy a service. Questions for further research are presented. Finally, a bibliography will be provided to assist readers who are interested in additional reading on the topic.

II. ISSUES RELATED TO MAKE-OR-BUY ANALYSIS

A. BACKGROUND

The DoD health care system is trying to address the increasing cost of providing health care, as is the case in the private sector health care industry. Health care policy is a complex issue area given the dynamic environment in which costs have risen.

1. The Reduction of the Federal Budget Deficit

From a broader perspective, an important issue influencing the drive to reduce costs is the intent to reduce the United States government annual budget deficit and debt. These have increased due to a number of variables including trade with other countries, entitlement spending (i.e., social security, Medicare, and Medicaid benefits) and the resulting interest that accrues on the deficit. In attempt to reduce the budget deficit, Congress has consistently reduced the DoD real dollar funding level since the end of the Cold-war. This has occurred because, in the view of elected officials, the DoD no longer needs to maintain as large an infrastructure and budget to achieve the appropriate level of post-Cold-war national security.

2. DoD Changing Roles and Missions

The end of the Cold-war has dramatically changed the way DoD operates. During the Cold-war, the DoD mission was to maintain a high level of national security to ward off or endure the possibility of a long-term conflict with a rival super power. Since the end of the Cold-war, DoD has downsized the number of military and civilian personnel, completed three rounds of Base Re-Alignments and Closures, and reduced spending levels. Today, the DoD focuses on ability to respond to two

regional conflicts that may occur simultaneously at two different regions in the world, to participate in peacekeeping efforts, and to provide humanitarian assistance when required.

In addition to achieving the national security level necessary in the current global environment, the DoD is also planning to modernize for the future to ensure the United States maintains technological superiority over any potential enemy or threats. Therefore, the DoD is searching for ways to reduce costs and increase efficiency while maintaining readiness so savings can be used to upgrade and replace current warfighting and support infrastructure, including military health care systems. One method to discern alternatives that will best achieve cost savings is to use make-or-buy analysis.

3. The Health Care Crisis

At the health care industry level, the public and private sector health care systems face similar problems. Both are reforming to reduce or, at least, control rising health care costs and increase access to health care. Methods used to address these health care issues include capitation, managed care, and outsourcing.

4. The Commercial Activities Program

Contracting out, or outsourcing, commercial activities has been the national policy since 1955. Due to legislative and administrative restrictions, however, this policy has been largely under-enforced. Today, due to the dynamic external and internal environments, BUMED is beginning to expand the use of contracting out commercially available activities to support its mission.

In October 1995, BUMED formally assigned a commercial activity (CA) program manager to disseminate health care specific commercial activity program policy to MTFs. The commercial activity program manager also acts as the liaison between the MTFs and the Outsourcing Support Office (OSO). The OSO, a joint venture of the Naval Facilities Engineering Command (NAVFAC) and Naval Supply Systems Command (NAVSUP), to assist Commanding Officers and their staffs by facilitating liaison with field contracting offices, providing advise on developing solicitations and cost comparisons, and sharing lessons learned.

Although the OMB Circular A-76 and the Center for Naval Analysis (CNA) study on *Outsourcing and Competition: Lessons Learned from DoD Commercial Activities Programs* reveals that commercial activities (CA) for contracting out include nursing services, clinics and dispensaries, hospital care, dental care, surgical care, and pathology services, BUMED and MTFs have not completed CA studies (i.e., make-or-buy cost comparisons) in these areas.

Since contracting out activities through CA studies typically results in replacing in-house personnel with contractor employees, MTFs prefer to contract out portions of these functions through Managed Care Service Contracts that augment, rather than replace, in-house performance of the work. As a result, MTFs limit CA studies to non-medical commercial activities such as food service, laundry service, and child care. BUMED, however, is studying Naval hospital inventories of military and civilian personnel billets that provide core support for achieving the BUMED mission. From this study, BUMED will be able to identify support activities that are commercially available and

determine the potential for contracting these functions out. This study should enable BUMED and MTFs to expand the use of contracting out as a management tool to achieve the BUMED mission "to provide timely and efficient health care to warfighters during times of conflict and to deliver cost-effective health care during peacetime."²

5. Stakeholder Interests

At the MTF level, Commanders have a variety of interests to consider when making resource management decisions. At the U. S. government level, MTF Commanders should consider how decisions impact efforts to reduce the budget deficit and how to spend tax payer dollars efficiently and cost effectively. At the DoD level, MTF Commanders need to consider how to: maintain high levels of readiness for rapid response to regional conflicts, contingency operations, humanitarian assistance, and disaster relief anywhere in the world; provide high quality training programs, work and living conditions, pay, and benefits, to attract and retain quality personnel; and invest in technology that will modernize the military health care system and ensure technological superiority.

To support the BUMED mission, MTF Commanders need to consider clinical care, education, and research. Finally, MTF Commanders need to consider the interests of their staff of military and civilian medical and support personnel, the needs of the patients, and the short- and long-term health care goals that support the MTF mission. MTF Commanders can no longer identify capital, personnel, and equipment requirements and relatively easily acquire these assets. The MTF

²Bureau of Medicine and Surgery, "U.S. Navy Medicine '... From the Sea,'" <<http://support1.med.navy.mil/bumed/bumed.html>>: 1-2.

Commanding Officer must develop and implement an objective and justifiable strategy for allocating MTF resources.

B. WHAT IS OUTSOURCING?

In this section, outsourcing and related terms will be defined. Although these terms are not specified in OMB Circular A-76, they are used by DoD and DoN leaders responsible for developing and implementing the commercial activity program. Commonly used in both the public and private sector, these terms are "privatization," "outsourcing," and "partnering." In addition, definitions of terms used in OMB Circular A-76 will be discussed to address interpretation issues. While reading these definitions note that, despite the various interpretations associated with outsourcing, the DoD has successfully contracted out everything from the manufacture of weapons systems and aircraft to delivery of laundry and dry cleaning services.

1. Common Terms

Many DoD and DoN personnel have heard the terms "contracting out," "outsourcing," "partnering," and "privatization" when the subject of contracting has been discussed. Few understand the subtle differences between these terms. Once these differences are understood, MTF Commanders can determine which, if any, of these alternatives best meets the mission and goals of the MTF.

a. Contracting Out

Contracting out is defined in the CNA study as shifting the provision of a commercially available good or service to the private sector by competitive bid. Services can be provided either at the MTF or contractor facilities. Contractors may use their own equipment and

personnel, or the government's equipment, or a combination of both. For example, janitorial services at MTFs can be contracted out yet the contractor personnel, equipment, and supplies are located at the MTF.

b. Outsourcing

Outsourcing is another term for contracting out. As defined by the CNA study, it is the transfer of functions from in-house to private sector performance. For practical purposes, the terms contracting out and outsourcing will be used interchangeably throughout this thesis.

c. Partnering

Partnering occurs when the MTF and private contractor combine as a team to form common objectives and goals in providing a service. With this arrangement, the contractor has a vested interest to keep costs down and quality up.

d. Privatization

The OMB Circular A-76 describes privatization as "the process of changing a public entity to private control and ownership."³

2. Commercial Activities

According to OMB Circular A-76, commercial activities are "operated by a Federal executive agency and which provides a product or service which could be obtained from a commercial source."⁴ The Circular further states that a commercial activity "is not a government

³Office of Management and Budget, *Revised Supplemental Handbook on Performance of Commercial Activities*, Circular Number A-76 (Washington D.C.: Government Printing Office, 1996) 24.

⁴Office of Management and Budget, *Performance of Commercial Activities* 2.

function ... and may be part of an organization or a type of work that is separable from other functions or activities and is suitable for performance by contract."⁵ Policy makers and implementers are concerned that improper interpretation of commercial activities could lead to contracting out activities the government should perform.

3. Core Versus Non-Core Activities

Generally speaking, core activities contribute directly to mission accomplishment and should not be contracted out. Conversely, non-core activities are not essential to mission accomplishment but, when performed, support mission accomplishment. These activities can be contracted out.

The Deputy Chief of Naval Operations (DCNO) for Logistics (N-4) Outsourcing Process Action Team (PAT) defined core activities as,

only those functions performed by personnel required in a direct combat or combat support role or which are required to address military manpower considerations such as sea-shore rotation. All other activities performed in support of the Navy's core warfighting mission are non-core and should be considered as potential candidates for outsourcing or privatization.⁶

It remains to be seen whether or not this definition will become accepted across DoN agencies.

Interpretations of core and non-core activities vastly differ, however. An activity deemed mission essential to one command may not be deemed mission essential to another command. The Deputy Under Secretary

⁵Office of Management and Budget, *Performance of Commercial Activities* 2.

⁶Deputy Chief of Naval Operations for Logistics (N-4), "Outsourcing PAT Team Minutes -- Meeting 24 & 25 October 1995," <<http://n4.nosc.mil/n46/minute2.html>> 25 October 1995: 5.

of the Navy's statement during the 24 - 25 October 1995 DCNO (N-4) Outsourcing PAT meeting describes the reason interpretations of core activities vary: "Times have changed so dramatically that all past assumptions about what the government is and what it should be doing are all being re-thought. What was viewed as a core function during the Cold-war, may no longer be so viewed."⁷ Standardizing the definition of core and non-core activities is important because it will enable DoD and DoN personnel to determine which activities may be outsourced.

Specifying a standard definition for core activities that will lead to the same interpretation across all agencies is not a problem limited to DoD officials. The private sector is struggling with this issue as well. Ravi Venkatesan, of Cummins Engine Company, classifies activities as strategic, or core, in the article, "Strategic Sourcing: To Make or Not to Make," when they:

have a high impact on what customers perceive as the most important product or service attributes such as, high quality, fast response, and low price; require highly specialized skills and specialized assets for which there are very few capable suppliers; and involve technology that is dynamic and for which there is a possibility of gaining a technological lead.⁸

Venkatesan further recommends retaining in-house:

those services which are critical, or core, to the service being provided and that the organization is distinctly good at making ... while services in which suppliers have a

⁷Deputy Chief of Naval Operations for Logistics (N-4) 7.

⁸Venkatesan, Ravi, "Strategic Sourcing: To Make or Not to Make," *Harvard Business Review* November-December 1992: 102.

competitive advantage, such as greater economies of scale, lower cost structure, or a stronger commitment to improving performance should be outsourced.⁹

Leaders in both the public and private sectors generally state that firms should outsource functions that can be provided faster, better, and cheaper by a contractor.

Indeed, both the public and private sectors are working to standardize the definitions of core and non-core activities. The importance of these definitions lies with concern over the danger of outsourcing an activity the organization should retain sole responsibility for. DoD and DoN agencies have the added responsibility of outsourcing support functions while remaining responsible for managing the delivery of these services to the public.

4. Inherently Governmental Functions

Policy Letter 92-1 from the Office of Federal Procurement Policy entitled, *Inherently Governmental Functions*, establishes Executive Branch policy of what is and is not considered an inherently governmental function. The purpose is to ensure government personnel do not transfer governmental responsibilities to contractors. The Policy Letter defines inherently governmental functions as:

a function that is so intimately related to the public interest as to mandate performance by government employees. These functions include: (1) the act of governing, (i.e, the discretionary exercise of government authority), and (2) monetary transactions and entitlements.¹⁰

⁹Venkatesan 98.

¹⁰Office of Federal Procurement Policy, *Inherently Governmental Functions*, Policy Letter 92-1 (Washington D.C.: Government Printing Office, 1992) 1-2.

Many DoD personnel understand that DoD billets requiring personnel to act on behalf of the government or make policy decisions are inherently governmental functions that cannot be outsourced. However, private sector employees can be contracted to collect information to be used to make policy decisions then assist in implementing the new policy. The concern is that one agency interpretation of an inherently governmental function may not be the same as that of another agency. This may result in outsourcing activities that should be provided by the government.

5. Competition

Empirical data suggests the key to cost savings stem from competition rather than outsourcing. According to the CNA study, competitions result in average savings of 20% when in-house personnel win the bid and an average savings of 30% when the contractor wins the bid. The CNA study reveals that, of 2,138 competitions completed between 1978 and 1994, 48% or about half, resulted in performance in-house. The conclusion is savings come from competition, regardless of whether the service is provided by in-house or contract personnel.

6. Summary

Contracting out covers a range of possibilities. MTFs can shift a function from in-house to contractor delivery or get out of the business of performing the function by selling the function and assets to the contractor that will take over performance of the function.

The public and private sectors continue their efforts to standardize the definitions of commercial activities, core and non-core activities, and inherently governmental functions. Once achieved,

public and private sector agencies should be able to: clearly distinguish between activities that should remain in-house versus those available for outsourcing and competition; dispel concerns over outsourcing activities that should remain in-house; and communicate clearly when contracting out commercial activities.

C. WHAT SHOULD BE OUTSOURCED?

An estimated one million federal employees are currently performing services that could be delivered by the private sector. Meanwhile, government outsourcing is expected to increase 5% annually through the year 2000 to become a \$1.9 billion per year industry, according to Lisa Corbin's "Integration/Outsourcing Guide" in the Government Executive. In the private sector, many companies are outsourcing non-core functions, including hospitals. For example, The Outsourcing Institute, a non-profit research organization, referred to the Hospitals and Health Network 1995 Annual Survey on outsourcing that indicated 67% of hospitals use contractors for at least one department. Of these, 90% use contractors for business and clinical support services. This trend shows no sign of slowing down in either the private or public sectors.

Projected savings from outsourcing range from \$4 billion to \$10 billion per year, based on various DoD generated reports. Due to significant savings that can be achieved through outsourcing and ability to use these savings toward modernization, proponents of outsourcing suggest the DoD should follow the private sector's lead. The DCNO (N-4) Outsourcing PAT points out that outsourcing and privatization are tools managers can use to increase efficiency and that "the paradigm of change

we are in assumes that the current scope of government is too large and, like the private sector, government should shed functions that are ancillary to or not part of its accepted mission."¹¹ Some public and private sector officials propose that just about anything can be outsourced. Opponents warn that managers who assume they can outsource anything may outsource a function mission critical to the organization and lose control over that area. Dr. Joseph, OASD (HA), warned the audience at the TRICARE Conference in January 1996 that, while outsourcing appears to be a simple solution to health care issues, severe cuts in power, infrastructure, and funding levels could result. These levels cannot be quickly or easily regained should the need for re-building national security and defense arise.

Given that government is in an era of outsourcing, which activities should be contracted out? Efforts are underway to review all DoD functions to determine which activities the military should perform. As part of outsourcing efforts headed by DCNO for Logistics (N-4) headquarters in Washington D.C., working groups are in Jacksonville, Florida and San Diego, California to review individual activities region by region. The purpose is to look at every function and duplication of activity to answer these three questions: "(1) Can DoD get of the business altogether? (2) Can the activity be done more efficiently? and (3) Can it be done elsewhere?" The results of this regionalization study will help determine:

- how functions can be centralized;
- how performance standards and measures can be developed;

¹¹Deputy Chief of Naval Operations for Logistics (N-4) 6.

- the state of the commercial market; and
- how to review military specifications and match them with commercial sector standards.¹²

On other fronts, the DoD commissioned a Defense Science Board Task Force to determine activities DoD is performing in-house that the private sector can provide with greater efficiency, at lower cost, and higher quality. The Board recommended outsourcing training, optometry services, medical libraries, laboratories, testing services, equipment maintenance, and pharmacies.

In DoD health care, OMB Circular A-76 lists nursing services, clinics and dispensaries, hospital care, dental care, and surgical care as commercial activities. The CNA study reviewed the military's progress in outsourcing these services and found that, while outsourcing nursing services can produce an estimated savings of \$116 million, only 6% of these billets are outsourced. Outsourcing clinics and dispensaries, the study continues, can produce savings of \$89 million per year but only 3% of these are outsourced. Outsourcing hospital care can provide an estimated savings of \$75 million per year but only 15% of these services are outsourced. While outsourcing dental care can produce an estimated annual savings of \$51 million per year, only 6% of these services are contracted out. Finally, surgical care can generate savings of \$50 million per year, yet only 2% of these services have been outsourced. The reasons for retaining these services in-house are sea-shore rotation and career progression of military personnel.

¹²Deputy Chief of Naval Operations for Logistics (N-4) 2.

The CNA study estimated that about 36% of military personnel are performing activities that can be outsourced. The benefit of outsourcing military billets, rather than civilian billets, is that cost comparisons may not be required when enlisted or officer billets are replaced by contract employees. The study also suggests that cost comparison and competition of military billets yields average savings of 50% and that these savings are large because of the cost to rotate military personnel to new jobs every few years.

Although nutrition, medical, dental, surgical, and mess services are not contracted out as commercial activities because of the sea-shore rotation and career progression restrictions, they are contracted out under managed care. The reasoning here is Managed Care Service Contracts augment in-house staff while commercial activities contracts tend to replace in-house staff with contract employees.

As mentioned above, these military billets are protected from competition because outsourcing them presents problems with training, career progression, and retention of military personnel who remain in jobs that have been outsourced elsewhere. Specifically, outsourcing these billets effects the sea-shore rotation and readiness of military personnel by removing the number of shore based billets that require use of skills personnel will employ during sea duty. In addition, ability to outsource some of these billets may be limited by the minimum active duty health care personnel requirements and the number and size of the MTFs needed in the United States to perform these services. However, these reasons are Navy, rather than externally imposed constraints.

Furthermore, the Surgeon General has the discretion to determine which activities or billets can be contracted out as commercial activities.

Commanders of MTFs may be reluctant to outsource health care services listed in OMB Circular A-76 as commercial activities but, in light of the recent CNO message directing CA studies, tough decisions must be made concerning the functions being outsourced as commercial activities. The CNO message, date-time-group 082326Z JAN 97, announced the first list of activities to be studied by the fleet for outsourcing. In this message, MTFs and other DoN facilities have been directed to conduct cost comparisons on the following activities: ADP, motor vehicle maintenance, child care, occupational health, and pest management.

The CNA study reports that most of the health care billets are paid by the Defense Health Program managed by the OASD (HA). MTF Commanders are recommended to request transfer of savings related to contracting out commercial activities to the MTF. This is not an unrealistic request considering Deputy Defense Secretary John P. White signed a memorandum of February 26, 1996, enabling DoD components to use the savings generated from outsourcing toward modernization. Indeed, the potential exists for achieving significant savings by outsourcing health care services. The CNA study reports that the average annual savings per billet is \$18,000 (in 1996 dollars). Considering that an estimated 30,000 military and civilian health care workers are performing commercial activities, the average potential savings from outsourcing these billets is estimated at \$540 million per year. If even a small number of these billets can be outsourced, it will

contribute to the overall efficiency and effectiveness of the DoD and provide MTFs the opportunity to use in-house personnel elsewhere.

While outsourcing offers the potential to reduce costs and increase efficiency for a wide range of support activities, the DoD report, *Improving the Combat Edge Through Outsourcing*, recommends these activities should be considered for outsourcing when three conditions exist:

First, private sector firms must be able to perform the activity and meet our warfighting mission. DoD will not consider outsourcing activities which constitute our core capabilities. Second, a competitive market must exist for the activity. Market forces drive organizations to improve quality, increase efficiency, and reduce costs. Third, outsourcing the activity must result in the best value for the government and therefore the taxpayer.¹³

The report concludes that savings derived from outsourcing will benefit modernization efforts. The Commission on Roles and Missions (CORM) of the Armed Forces believes that "expanded outsourcing will help DoD adjust to the falling budget and a new world environment without giving up the quality of support [the DoD] needs to ensure an adequate national defense."¹⁴

Obviously, outsourcing is not appropriate in all cases. According to the RAND report, written by Frank Camm, for the CORM, *Expanding*

¹³Department of Defense, *Improving the Combat Edge Through Outsourcing* (Washington D.C.: Government Printing Office, 1996) 4.

¹⁴Camm, Frank, *Expanding Private Production of Defense Services*, Report sponsored by the Commission on Roles and Missions of the Armed Forces (CRMAF) under RAND's National Defense Research Institute (California: RAND, 1996) 3.

Private Production of Defense Services (commonly referred to as the CORM report), successful commercial firms become more reluctant to outsource an activity as:

- real time control of a complex process becomes more important;
- the potential joint value to buyer and seller of employing customized assets grows, especially in an uncertain operating environment; or
- it becomes harder to specify the performance desired in a contract well enough to enforce the contract in court.

Where appropriate, the report concludes, DoD can outsource when it is cost effective.¹⁵

One method for identifying which activities and respective billets qualify for outsourcing is to recall the health care mission is to ensure healthy people are available to meet the Navy war time and daily operational readiness missions. Achieving these missions involves deployment of health care professionals on board ships, hospital ships, overseas military health care facilities, and with the Fleet Marine Force. Stateside, these missions are achieved by providing training and support for forward deployed medical units and various levels of medical and dental care services for active duty personnel. By identifying the inputs required to provide these services, MTF Commanders can determine which functions are core to the missions and which billets deploy and mobilize. Once these determinations are made, MTF Commanders can focus on outsourcing activities and respective billets that are non-core, not deployable, and not mobilized.

¹⁵Camm 38.

D. WHAT CRITERIA SHOULD BE USED TO EVALUATE THE MAKE-OR-BUY DECISION?

One method to address this question is to identify the criteria and the minimum threshold requirements for each criteria that must be met before outsourcing will be approved. If potential contractors are able to meet these thresholds, then outsourcing is possible. Conversely, if the bidders cannot meet or exceed these thresholds, then outsourcing is not attractive and other service delivery alternatives should be considered.

The qualitative and quantitative criteria and related variables to evaluate the make-or-buy decision must be identified early in the outsourcing initiative. Some criteria will be mandatory to consider, as described below. Although these must be considered, other criteria and related variables should also be included in the make-or-buy decision process. This requires the relevance of each criterion and variable to be established then weighted and listed in priority of importance to the decision maker. This provides the MTF Commander an outline to guide the decision process and reduces the potential for losing sight of the relative importance assigned to the quantitative and qualitative criteria and variables to be considered. Suggested criteria will be described in this section while variables will be discussed in the next section.

An MTF Commander has the criteria set forth in OMB Circular A-76, CNO messages, and MTF Board of Director meetings to consider when evaluating the make-or-buy decision. These criteria should consider the

potential for organizational upheaval, transfer of important assets, relocation of people, and long-term contractual relationships with a contractor.

As to OMB Circular A-76 criteria, an activity must meet certain criteria before contractor performance of the commercial activity will be approved. Specifically, the activity must: 1) meet Secretary of Defense approval when related to national defense or intelligence security; 2) not be an inherently governmental function; 3) have satisfactory commercial sources available; 4) meet or exceed generally recognized industry performance standards; 5) be fair and reasonably priced; 6) have cost estimates consistent with the President's Budget; 7) meet the minimum cost differential (i.e, savings) of ten percent of in-house personnel costs or \$10 million over the performance period; and 8) not establish an employer-employee relationship between the government and contractor employees.

The OMB Circular A-76 states that make-or-buy cost comparisons will be conducted: 1) when activities do not meet established performance standards; 2) when there is reason to believe fair and reasonable prices may not be obtained by commercial sources; or 3) as necessary to permit conversion of work to or from in-house or contract.

At the MTF level, the Commander should consider using the following criteria to evaluate the make-or-buy decision. The benefits should outweigh the costs of outsourcing.

1. The Mission

Outsourcing support activities should permit in-house personnel, equipment, and capital to be focused on performing operational activities that contribute directly to mission accomplishment.

2. Readiness

Contracting out support activities should enable in-house personnel to hone operational skills necessary to support wartime and other operational readiness requirements. When outsourcing contributes to MTF ability to focus in-house resources on readiness, the activity should be contracted out.

3. The Best Interest of Patients

Commanders of MTFs should focus on employing the combination of in-house and contract resources to perform the services that are in the best interest of healthy patient outcomes.

4. Full Time Equivalent (FTE) Civilian Employee Limits

In the DoD, agencies have civil service employee FTE thresholds that cannot be exceeded. Although OMB Circular A-76 prohibits contracting out solely to meet FTE limits, replacing in-house personnel with contract personnel may result in meeting this requirement. Therefore, outsourcing is one way to indirectly stay within FTE limits.

5. Costs

Can the contractor perform the service at lower cost than if provided in-house? This determination requires completion of a most efficient organization (MEO) plan and a make-or-buy cost comparison.

The basis for all costs considered in government cost analyses is the MEO. Based on the Performance of Work Statement (PWS), the MEO

refers to the MTF in-house mix of federal employee and contract support requirements for performing a service in-house. The MEO is the product of the management plan, a plan that outlines organizational changes that will result in the MTF's MEO to perform an activity in-house. This document provides staffing patterns and operating procedures that serve as a baseline for in-house costs.

Once the MEO is completed, the cost comparison may be initiated. Two types of cost comparisons are used based on the number of FTE personnel affected by the decision. The streamlined version is called a simplified cost comparison. This method may be used for activities meeting the following criteria: the activities facing conversion from or to in-house, contract, or Inter-Service Support Agreement (ISSA) performance involve 65 or fewer FTEs; the activity will compete largely on a labor and material cost basis; the conversion will not require significant capital asset purchases or equipment requirements will be government furnished/contractor operated; and involves activities commonly contracted out by the public or private sector meaning that there are no less than four comparable agency contracts of the same general type and scope. Activities not meeting these criteria require a full cost comparison.

Simplified cost comparisons can be completed and signed through the chain of command within one month depending on the availability of accurate cost data and the geographic locations of the signature authorities. It has typically taken 24 months to complete simplified cost comparisons. The streamlined method introduced into the A-76

Supplement in March 1996 should reduce this to completion time to an average of 18 months. The goal is to reduce this time to an average of 12 months.

The full cost comparison takes an average of 48 months to complete. Since several restrictions and constraints were removed when the A-76 Supplement was revised in March 1996, the goal now is to complete standard cost comparisons within 36 months.

When the cost comparison is completed, the next step is to compare the MTF's cost estimates against the contractor's. Recall that OMB Circular A-76 requires a threshold savings of ten percent of personnel costs or \$10 million over the performance period for outsourcing to be considered. Therefore, if this criterion is met, then the service should be outsourced.

6. Quality

Assess the MTF's internal expertise and capabilities. How well does the in-house staff perform the activity? Will training or better equipment improve in-house performance? How much would it cost to perform as well as the best contractor? Can the MTF afford it? Compare in-house performance to contractor performance of the activity to determine whether contractor service capabilities can meet or exceed MTF capabilities.

7. Volume of Service

Is the contractor willing and able to adjust personnel, equipment, and capital requirements to match fluctuations in the volume of the service being performed? For example, if two food servers are initially contracted but the MTF later determines it needs four food servers, the

contractor should be able to provide the four food servers that are needed. The more willing and capable the contractor is in this area, the more flexibility the MTF will have in matching changes in service volumes.

8. Top Management Support and Involvement

Top management in DoN MTFs consists of the Board of Directors (BoD) or Executive Steering Committee (ESC). The BoD or ESC typically includes the Commanding Officer, Executive Officer, directors, and senior enlisted advisor. Outsourcing is most successful when top management drives the outsourcing initiative and supports efforts to implement it. According to the CNA study, outsourcing efforts have been less successful at facilities where top management has not actively supported the initiative.

The BoD should develop an outsourcing plan that will result in the most efficient and effective use of resources needed to support the mission. For example, top management may provide the vision, tools, goals, and incentives to support the mission. The vision may be to have in-house personnel perform services that contribute directly to the mission and to have contractors perform commercially available support activities. Tools for achieving support of the mission may be outsourcing and make-or-buy cost comparisons of support activities. The goals should be to reduce costs and increase quality whether the activity is performed in-house or by contract. Commanders can encourage outsourcing by providing incentives. One incentive is savings achieved from outsourcing may be retained by the outsourcing MTF for modernization expenditures.

The outsourcing plan should include a list of commercial activities to be considered for outsourcing. Once listed, activities should be selected and prioritized based on the likelihood that outsourcing them will improve cost effectiveness of support services without causing unacceptable risks should outsourcing not work as planned. Contract out the most promising activities first to achieve early successes that build confidence in outsourcing and enable the MTF to expand its outsourcing efforts as confidence and capability increase over time.

For each activity to be outsourced, the BoD should set measurable goals that determine whether the desired activity can be outsourced cost effectively. For each goal, the BoD should develop additional objectives. For example, an overall strategy may be to increase the quality and cost effectiveness of food service. The Comptroller can then develop economic goals and objectives to determine if it is better to provide food service by in-house or contract personnel. If food service is outsourced, this information can then be used to measure actual contractor performance.

9. MTF Culture

Formally plan for organizational and cultural changes required to implement outsourcing. The MTF's culture is to heal sick people and serve the country. In addition, military culture tends to be conservative, preferring to operate in a traditional manner. The private sector, however, does not operate this way. Therefore, it is necessary to compare the MTF and contractor cultures to identify methods for overcoming barriers that may prevent successful outsourcing. This

may require a change in the MTF's business processes, such as, task requirements, technology, systems, people, organizational structure, economic environment, political environment, mandates, visions, values, and missions. Culture takes a long time to change. However, cultural changes are necessary to gain internal acceptance of outsourcing and to achieve successes in its implementation.

10. Stakeholders

The MTF Commander should identify issues significant to the MTF's internal and external stakeholders, and how the MTF will address those issues. Input from internal and external stakeholders should be requested during the planning phase because outsourcing efforts will be more successful if the MTF considers who the stakeholders are and includes them in the planning process.

Stakeholders include MTF personnel, MTF managers, patients, contract employees, contract managers, tax payers, elected officials, and upper echelons in the chain of command. OMB Circular A-76 requires affected in-house personnel and their unions to be notified of and included in outsourcing efforts.

The MTF manager should expect political opposition when outsourcing negatively impacts the employment level of the local community and develop a strategy for addressing it. Despite this, there will be considerable political pressure to maintain physical infrastructure of medical facilities during a time when MTF civilian, military, and reserve end-strength continue to be downsized.

11. Personnel Relocation

An essential component of the contract is the personnel relocation plan. This plan includes an introduction of the contractor to the MTF personnel, human resources office, and the work to be performed. The plan should also outline the required skills and include a transition plan for transferring in-house personnel to the contractor company. The MTF and the contractor should work together to prepare this plan. Contractors can be a valuable source of information about proven transition approaches. For example, the contractor should have a plan for assessing skills, an interview approach, and a decision making model for hiring personnel. The MTF and contractor should communicate with each other and with personnel throughout the transition process to help personnel view the change as an opportunity. As mentioned earlier, OMB Circular A-76 requires managers to notify affected in-house personnel and unions and keep them informed of plans to contract out a function. In addition, when in-house personnel needs are addressed, outsourcing is more successful for the personnel and the MTF.

When activities are transferred from in-house to a contractor, MTF civilian personnel will face relocation. Four common methods for relocating personnel include attrition, "first right of refusal," re-assignment within the MTF, and employment outside the MTF.

The first relocation method, attrition, involves the natural movement of in-house personnel from the MTF due to retirement or spouse's Permanent Change of Station. MTFs prefer this method because it removes the burden of having to choose which, among a quality pool of in-house personnel, will be relocated.

The second method is employment with the contractor. Outsourcing as a result of a CA study requires inclusion of the "first right of refusal" clause in the contract. Murrel Coast, from the Outsourcing Support Office, reveals favorable outcomes when this method is used. Personnel report being more satisfied in this arrangement than under the pre-outsourcing arrangement. Enhanced career progression and training opportunities are among the reasons personnel are satisfied working for the contractor.¹⁶ With this method, the employee interviews with the contractor and takes a position with the contractor but works at the MTF in the same or similar position previously held.

Re-assignment is the third method of relocating in-house personnel. Here, personnel are moved to other areas of the MTF to work. Personnel skills are often applicable to other areas of the MTF. When necessary, additional training is provided to match the employee's skills with the new position.

The fourth method for relocating personnel is employment outside the MTF or contractor organizations. Occasionally, in-house personnel skills do not match the requirements of the MTF or the contractor. In these cases, personnel need to find employment with another organization.

Throughout the BRACs, personnel relocation plans evolved that are still in use today as the DoD continues to reduce infrastructure. These plans include the "first right of refusal" clause, the DoD's Priority

¹⁶Coast, Murrel, Outsourcing Support Office (N-465), telephone interview on commercial activities cost comparisons, Washington D.C., 16 Jan 97.

Placement Program, the Defense Outplacement Referral System, the Non-Federal Hiring Incentive, the certification program, and the severance pay plan.

First, the Federal Acquisition Regulations 7.305 (c) and 52-207-3 require inclusion of the "first right of refusal" clause in solicitations for conversion from in-house to contractor performance.

Second, the DoD Priority Placement Program (PPP) assists in placement of DoD personnel elsewhere in DoD.

Third, the Defense Outplacement Referral System (DORS) makes DoD civilian and military personnel resumes available to prospective private industry employers.

Fourth, the Non-Federal Hiring Incentive, a Congressionally approved program, allows MTF and other DoD managers to provide re-training and relocation funds for personnel that are employed by DoD for at least one year.

The DoD provides re-training that enables personnel to obtain certifications or licenses needed for similar employment in the civilian sector.

The 1996 National Defense Authorization Act permits severance payments in lump sums rather than biweekly, continued health coverage for personnel facing layoff, and personnel in similar jobs to volunteer to replace personnel on the reduction-in-force list.

12. Convenience

How distant is the commercial source from the MTF? The closer the commercial source, the less likely delays will occur in service delivery due to traffic congestion, road construction, flooding, or other natural disasters.

When outsourcing a service that requires patients to go to the commercial source, the contractor facility should be conveniently located for patients. It is useless to contract out to a facility that is inconvenient for patients to access. Patients may prefer not to seek treatment because of the inconvenience. An alternative is to bring the contractor resources to the MTF. One hospital contracted to have a Magnetic Resonance Imaging (MRI) truck park outside the MTF three days per week to serve patients needing this procedure. The MTF gains by reducing the personnel, equipment, and capital cost of providing the service. Meanwhile, the patient gains convenient access to the service.

13. Measure Contractor Performance

Specific performance measures should be in place to measure both the in-house and contractor performance of the service. This enables the MTF to determine whether contractor performance is better, as good as, or worse than the in-house staff capability. For example, if contractor costs rise and quality decrease below the minimal acceptable level, then contract modifications may be required to remedy the situation.

14. Contractor Selection

Source selection is an important aspect of contracting out services. According to Susan Harvey's *Program Manager* article,

"Outsourcing Government Functions -- A New Look At An Old Challenge," the Deputy Secretary of Defense requires DoD to conduct best value analysis, evaluate cost, and past performance of bidders to "demonstrate reliability, timeliness, and quality service delivery."¹⁷

Part of the source selection process is to screen out unqualified bidders. This entails development of a clearly defined PWS that outlines the scope of the work to be performed. Combined with the contract, these documents spell out each party's responsibilities.

Source selection includes a best value approach that establishes clear criteria to evaluate contractor capabilities. Since the enactment of the Federal Acquisition Streamlining Act (FASA) of 1994, Federal Acquisition Reform (FAR) Act of 1996, DoD Directive 5000.1, and DoD Regulation 5000.2, the government no longer needs to accept the lowest bidder. Quality and performance criteria are now the preferred criteria to use when contracting. Another approach for selecting a contractor is to evaluate the MTF's existing relationship with the contractor.

15. Contractor Management

There are a variety of ways to manage contractors. Regardless of the method used, establishing open communications and good working relationships are important aspects of successful outsourcing.

Communication between the MTF and the contractor are critical if MTF and contractor outsourcing plans and service level commitments are to be agreed upon. Confirm that the contractor will submit reports regularly to ensure effective, efficient, and economical service

¹⁷Harvey, Susan, "Outsourcing Government Functions -- A New Look At An Old Challenge," *Program Manager* November-December 1996: 46.

delivery. This ensures that control remains with the MTF. Ensure the contractor understands MTF objectives so appropriate resources will be used to deliver the service.

It is equally important to establish a good working relationship with contractor employees. This can be accomplished by introducing contractors and their employees to the MTF, allowing them to become familiar with the MTF's operations, and acquainting them with in-house personnel. The key is a relationship that gives the MTF access to the best business practices, professional knowledge, and practical information about the commercial activity.

If contractors change, they must be managed differently, requiring different management skills. It will be necessary to establish open communications and a good working relationship with the new contractor to facilitate continued successes in outsourcing.

16. The Contract

An important element of outsourcing is the service contract. The contract defines the quality, timeliness, and economy of the services that are expected. If confidentiality is a concern, this should be written into the contract. Furthermore, goals should be established, and measures should be outlined so both parties come to a mutual understanding of the type of service that is expected. These elements should be specified in detail. While it is necessary to be as specific as possible in stating the service to be performed, how it is to be performed, who will perform it, and when, it is equally necessary to include flexible contract terms to enable the contractor to perform the

service and to allow minor adjustments to be made to the contract without the MTF incurring large fees for the changes.

The DoD can expand its use of outsourcing with effective contracts that outline the performance desired from contractors. Therefore, the CORM report suggests DoD should coordinate its outsourcing plans and acquisition reform efforts to ensure the best contracting vehicle is used to obtain responsive and reliable contractors.

There are various contracting approaches that can be used to tailor MTF needs. These approaches include billet-by-billet, function-by-function, all-or-part, omnibus, regional, or entire facility.

The billet-by-billet approach really is not available since OMB Circular A-76 states the activity should be separable from other functions or activities. This separability is required to facilitate cost comparisons between in-house and contractor performance.

Many DoD agencies prefer to outsource commercial activities function-by-function. The CNA study reported, however, that this method is least desirable because it limits the contractor's ability to efficiently use contract employees.

According to the CNA study, the "all or part" competition approach is becoming popular within DoD.¹⁸ Here, contractors either bid on the entire group of functions or only a small number of the functions based on the areas contractors feel most competitive. If the best bid comes

¹⁸Tighe, Carla E. and others, *Outsourcing and Competition: Lessons Learned from DoD Commercial Activities Programs* (Virginia: Center for Naval Analysis, 1996) 26.

from a bidder willing to perform the whole group of functions, then that bidder may be selected for contract award.

The DCNO (N-4) Outsourcing PAT proposed the use of omnibus contracts versus a function-by-function approach. An omnibus contract enables multiple functions at one facility to be contracted out under one contract. Ensure, however, the functions selected for omnibus contracting are similar to those available on the commercial market. The benefit of this approach is that the MTF has to monitor only one contract although the prime contractor can subcontract some of the functions.

Regional contracting is also recommended by the DCNO (N-4) Outsourcing PAT. With the recent regionalization of MTFs, this is a viable option. The benefit of this approach is reduced contract oversight costs without losing the flexibility to add or subtract contract employees to match demand for the service. This contracting approach allows contractors to use personnel more efficiently. One disadvantage is MTFs may accept poor performance in a small portion of the contract to prevent disruption in the overall contract.

The DCNO (N-4) Outsourcing PAT further recommends that, except where compelling national security interests dictate otherwise, small outlying facilities should be entirely outsourced. In fact, this is happening in Millington, Tennessee where the Naval hospital is being closed as part of the BRAC initiative.

E. WHAT VARIABLES SHOULD BE CONSIDERED TO FORM THE MAKE-OR-BUY DECISION?

Performance indicator, MEO, and cost analysis data contribute to the make-or-buy decision. MTF Commanders should approach the progress

reports and statistics, comptroller, efficiency review, total quality leadership, performance improvement, quality assurance, health care planning, and patient administration departments to prepare data used to form the make-or-buy decision.

Tools that facilitate the collection of data include accounting systems that appropriately account for costs and software that assists in cost comparisons. COMPARE, a software program developed by the Air Force, is being disseminated by the Naval Education and Training Command, Norfolk, Virginia for all Naval commands to use as a tool to ensure a level playing field exists when comparing in-house costs to contractor costs of performing a service. Variables to consider for successful outsourcing include the costs, quality of providing the service, and use of outside experts.

1. Costs

The main issue here is to have a clear understanding of the type and amount of all costs associated with the function or activity as currently being provided. For government agencies, determining the cost to perform a service either in-house or by contract requires a make-or-buy cost comparison. However, identifying and measuring these costs can be difficult. An approach for identifying and measuring costs is to figure out the physical outputs, such as number of meals served per day, then figure out the inputs (i.e., labor, equipment, and capital) needed to produce those outputs, or number of meals. Costs are then assigned to each of the inputs and summed to identify the cost of performing the service. The next step is to identify costs that change as a result of the outsourcing decision, such as one-time contract conversion and

contract monitoring costs. These are known as differential or incremental costs. The CNA study indicates that about 11% of the baseline contract cost should be calculated for initial competition costs and about 10% should be allocated for the recurring contract monitoring cost. These are among the relevant costs evaluated to make the outsourcing decision. This data is compared to contractor cost estimates to determine whether service delivery costs less to perform in-house or by contract.

Important to measuring costs is ability to segregate relevant from irrelevant costs. This requires an understanding of how costs behave. Time and volume cause costs to vary based on the decision to make or buy. When relevant costs occur over a period of more than one year, the make-or-buy cost analysis should account for costs effected by inflation using guidance provided annually in the President's Budget.

Costs will vary in value over time. In addition, costs will also vary with changes in volume of service delivery. These costs are depicted in Figure 1 below. Fixed costs, such as rent and supervisor salary, will not vary with volume changes. Other costs increase proportionally to volume. For example, double the number of meals served and the costs will double. These are variable costs. Semi-variable costs have both fixed and variable components. An example is electricity. The fixed portion is the cost to heat the building and light the passageways while the variable portion is the cost that increases as number of appliances used to prepare meals increases. Semi-fixed costs do not change within a certain range of service volumes, but increase when that capacity is exceeded. For example, food

service labor cost may be fixed up to a certain number or meals served. Once this capacity is exceeded, another food server must be added and a new range of meal service starts that can lead to another increase in volume.

Equally important but often overlooked are avoidable costs and opportunity costs. Avoidable costs are the costs that can be avoided by the decision. For instance, in making the decision to make, initial contract conversion and recurring contract monitoring costs are avoided. Opportunity cost results from consuming resources for one service that could have been used to for another service. It is the cost of the next best use of those resources. Conversely, costs erroneously included in cost analyses are sunk costs. These are costs that have already occurred in the past. For example, funds spent on labor for the past year are a sunk cost. Unless the resource can be sold as salvage, the cost is sunk. If equipment can be sold, the money received from sale of the asset is relevant as salvage value.

Important to remember is costs relevant to one decision may be more or less relevant in another decision. For example, food server labor costs are relevant to the decision to outsource food service but

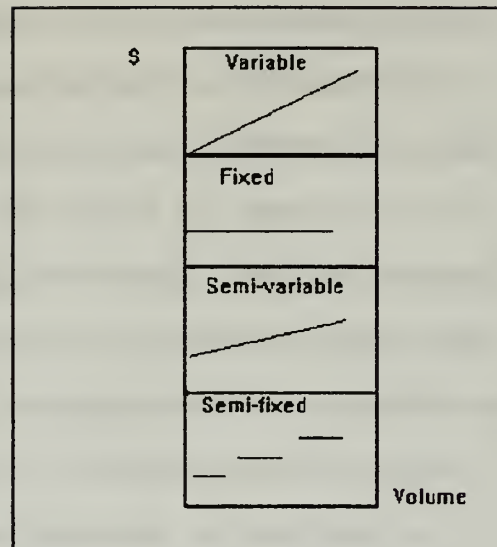


Figure 1 Cost Behavior
Source Adapted from
Holmes, Richard, L.
Lecture on *Relevant Cost Decision-Making*. Colorado Springs, Colorado, December 4, 1996.

these costs are not relevant to the decision to outsource laundry service and should not be included in this decision.

In summary, costs will differ based on whether the service is performed in-house or by contract. When a service is brought back in-house, the costs formerly paid to the contractor will go away. Costs that will not go away when the service is performed in-house include the equipment, space, personnel used to perform the service in-house. If outsourced, new costs arise, such as initial contract conversion and contract administration costs. Fixed costs, such as rent and supervisor salary, do not go away when outsourcing. Basically, costs should go away or be reduced to be relevant to the make-or-buy decision.

2. Quality

There are two issues here. One is having a clear understanding and measurability of the type and level of service being performed by the in-house or current contractor. The second is developing a clear understanding of the minimum type and level of service that will be acceptable for the function when provided in the future. This provides a benchmark to compare contractor quality of service. The general expectation is that outsourcing will result in equal or higher quality than currently provided. Therefore, an increase in quality of service provided by the contractor is an incentive for outsourcing.

3. Outside Experts

It may be prudent to hire outside experts to provide an impartial audit of MTF resource requirements, costs, and management of support activities. The consultants can recommend activities for outsourcing and even assist with developing an outsourcing plan. Consultants may

also provide valuable assistance in preparing a human resources plan to manage the relocation of affected personnel.

F. WHY OUTSOURCE?

In this section, the theory of outsourcing will be introduced. In addition, regulations guiding outsourcing will be discussed and common reasons for outsourcing will be described.

1. Theory of Outsourcing

One often hears a plan or initiative should be supported and driven from the top down. Outsourcing is no different. Both President Clinton and Vice President Gore have actively supported the government outsourcing initiative through directives, the budget, and repeal of restrictive laws. Congress has supported outsourcing through its Authorizations and Appropriations Acts. DoD leadership has reviewed old policy, generated several reports, consulted private industry leadership, and established Executive Steering Committees and working groups to identify activities for outsourcing and to streamline the outsourcing process. Is outsourcing hype or is DoD in the outsourcing business for good? Why is government relying more on the private sector for the provision of support services? The theory of DoD's outsourcing initiative is to improve readiness, generate savings for modernization, improve the quality and efficiency of support to the warfighters, and enable DoD to focus efforts on its warfighting mission.

a. *Economy*

The CORM, Defense Science Board Task Force, DoD, and CNA reports indicate the goal of outsourcing is to reduce costs and improve efficiency. The DoD report, *Improving the Combat Edge Through*

Outsourcing, states outsourcing will "help government agencies become more cost-effective and efficient ... to save money for modernization."¹⁹ Congress supported this goal throughout the 1996 Congressional Authorization and Appropriations Committee hearings on DoD military personnel and readiness. Here, the commitment was to outsource as much as possible to help offset budget reductions.

b. Efficiency

In theory, public-private competitions in a market economy save money and promote efficiency by directing non-essential functions to the most effective and efficient provider, whether in-house or by contract. LT Keith A. Weidenbach's article on, "Outsourcing: A DoD Initiative," supports the theory that DoD should enlist private firms whose "core competencies and efficiencies are in the service to be provided. This is efficiency brought on by expertise. The DoD goal should then be to outsource as many non-essential functions as possible."²⁰

c. Effectiveness

Deputy Secretary of Defense, John P. White, encouraged expansion of outsourcing during hearings before the Senate Armed Services Subcommittee on Readiness on April 17, 1996, stating the theory of outsourcing is:

to maintain and improve our combat effectiveness.
Outsourcing offers the opportunity to achieve that goal by

¹⁹Department of Defense 4.

²⁰Weidenbach, Keith, "Outsourcing: A DoD Initiative," *Navy Comptroller* 6(4) July 1996: 14.

generating savings for modernization, sustaining readiness, and improving the quality and efficiency of support to the warfighters.²¹

d. Modernization

Defense Science Board Task Force report, *Outsourcing and Privatization*, recommends outsourcing essentially all support activities to realize the maximum potential savings that will be re-directed toward modernization efforts.²²

e. Readiness

Both the public and private sectors encourage outsourcing to enable organizations to concentrate on core operations, activities unique and vital to organizational existence. For DoD, outsourcing permits increased readiness by enabling personnel to shift in-house resources from support to core activities. The idea is that DoD will contract out support functions and focus in-house resources on core operations.

f. Reduce Infrastructure

The DoD has drawn down military personnel, implemented hiring freezes on civilian personnel, reduced infrastructure via BRACs, but further infrastructure reductions are needed to achieve the cost savings needed for modernization. Outsourcing is a means to this end.

²¹Harvey 40.

²²Office of the Under Secretary of Defense (Acquisitions and Technology), *Outsourcing and Privatization*, Report of the Defense Science Board Task Force (Washington D.C.: Government Printing Office) 1A.

g. Change of Mind

Government agencies previously ignored the national policy of outsourcing and performed new functions in-house. The preference was to build a bigger government and produce most everything in-house. Therefore, the recent emphasis on outsourcing represents a change of thinking by government agencies. Today, DoD and other government agencies understand the need to work more economically, efficiently, and effectively. The result is a shift toward compliance with the long standing national policy requiring reliance on the private sector for goods and services when appropriate.

Government leaders continue efforts to remove barriers and simplify the outsourcing process. DoD and DoN leaders are committed to dramatically increasing the use of outsourcing to shed infrastructure and achieve the savings necessary to modernize for the future. As Susan Harvey states in the article, "Outsourcing Government Functions -- A New Look At An Old Challenge," the message is clear, DoD and DoN components need "to adopt the shift in paradigms from relying on in-house resources to relying on industry for goods and services and to identify appropriate candidates for outsourcing."²³

2. Outsourcing is Required

Statutes that mandate provision of goods and services by the private sector to the government are intended to facilitate outsourcing while others tend to place constraints on agencies, discouraging attempts to outsource. The following statutes encourage outsourcing.

²³Harvey 46.

Section 2462 of Title 10, United States Code, requires DoD to obtain services from private firms when they can provide them at lower cost. Section 367, HR 1530, *Increased Reliance on the Private Sector*, provides policy and guidance for expanding DoD reliance of the private sector for commercially available goods and services. Section 357 of the National Defense Authorization Act of FY 1996 requires the Secretary of Defense to endeavor to obtain commercial products and services from private sector sources.

Although the intent of this statute may have been to encourage outsourcing, it discourages this practice. Section 8037, a recurring provision of the 1996 DoD Appropriations Act, restricts the use of appropriations for cost comparisons not completed within 24 months for single functions or 48 months for multiple functions. While the time frame for completing cost comparisons averages 24 and 48 months, respectively, agencies failing to meet this time line despite best efforts are penalized.

Regulations can be contradictory. Section 2461 of Title 10, United States Code provides guidance on reporting requirements to Congress. As stated in the DoD report, *Increasing the Combat Edge Through Outsourcing*, DoD recognizes "the need for Congressional oversight of its management of support operations. However, DoD believes Section 2461 requirement for four separate reports is 'unnecessary.'" These requirements, the report adds, create "disincentives" for DoD Components to pursue outsourcing.²⁴ As a

²⁴Department of Defense 17.

result, these provisions complicate attempts to comply with other statutes requiring timely completion of cost comparisons.

a. OMB Circular A-76

The federal government has published policies on performance of commercial activities since 1955. The primary federal guidance on this subject is OMB Circular A-76. The A-76 Circular states the Executive Branch's policy for obtaining commercial goods and services from private sources to achieve best value for the government. The premises are that the government should not compete with the private sector and that the government should rely on the private sector to obtain the goods and services it needs. The Circular promotes competition of commercially available activities to achieve economy, efficiency, and productivity.

The Supplement to OMB Circular A-76 provides guidance for completing the cost comparisons necessary to determine whether activities should be performed in-house or by contract. This includes completion of an MEO to determine the personnel requirements to provide the good or service. The cost study averages 24-48 months or more to complete. Historically, the rules in the Circular discouraged government managers from complying with the national policy on outsourcing.

The OMB revised the Circular A-76 Supplement in March 1996. The revision represents an improvement over the previous version. Generally, the revised Supplement removes or eases barriers that existed in the previous version. The revision includes an improved methodology for conducting cost comparisons and promotes increased use of waivers.

Specific changes to the OMB Circular A-76 reporting requirements include: 1) elimination of study schedules and quarterly reports; 2) a new detailed reporting requirement for cost studies not completed within 18 months for single function studies and 36 months for multi-function studies; 3) elimination of the requirement to complete MEO implementation within 180 days; 4) a requirement for a transition plan for in-house or contractor performance on same time schedule has been added; 5) an increase in the annual productive labor hours from 1744 to 1766; 6) an overhead cost factor 12% of direct labor cost; and 7) cost of capital, severance pay, and contract administration.

Despite the recent changes to OMB Circular A-76, DoD remains concerned that the process is costly and time-consuming. According to the DoD report, *Increasing the Combat Edge Through Outsourcing*, cost comparisons cost hundreds of thousands of dollars and require 24 to 48 months to complete while the private sector completes cost studies in about 12 months. The current goal to complete cost comparisons within 18 to 36 months falls short of the private sector ideal. Having these private sector benchmarks to compare time lines with, DoD leadership remains committed to further streamlining commercial activities guidelines to make the outsourcing process itself efficient and cost effective.

b. OPNAVINST 4860.B

This document details Navy policy, procedures and responsibilities for determining whether commercial activities should be performed by in-house or commercial sources. This instruction is being

updated by the DCNO (N-4) Outsourcing PAT to reflect the revised commercial activity program policy set forth in the March 1996 Supplement to OMB Circular A-76.

c. CNO Directed Commercial Activity (CA) Studies

A CNO message to the fleet, date time group 082326Z JAN 97, announced the first list of activities to be studied for outsourcing. In this message, MTFs and other medical facilities have been directed to conduct cost comparisons on the following activities: ADP, motor vehicle maintenance, child care, occupational health, and pest management. Assistance is available through the Outsourcing Support Office established to facilitate outsourcing efforts at the local level. BUMED is the liaison between Navy MTFs and Dental Treatment Facilities and the Outsourcing Support Office.

3. Common Reasons for Outsourcing

The public and private sectors share a range of reasons for outsourcing: cost reduction, concentration of core business, access to skilled staff, and reduction in management time.

a. Improve Organizational Focus

For public and private sector organizations, a common reason for outsourcing is that routine day-to-day issues monopolize management's time and attention. This creates financial and opportunity costs that impact operations. Outsourcing is a management tool that can lead to a more effective focus on achieving the mission. It enables MTFs to focus resources and efforts toward core activities while having

contractor personnel perform support services. Support issues will still have to be managed but less frequently and by fewer contract administrators or program managers.

b. Access to World-Class Capabilities

The private sector can contribute world-class capabilities from their field of specialization. In many cases, contractors have gained experience and specialized industry expertise in their business as the result of extensive investments in technology, methodologies, and people over many years. Outsourcing permits MTFs to take advantage of private sector expertise, skill, processes, or technologies to satisfy specific support requirements.

c. Accelerate Reengineering Benefits

Outsourcing is often the product of another powerful management tool, business process reengineering. Reengineering is the basic restructuring of business processes. The goal is to improve measures of performance, such as, cost, quality, service, and speed. A lot of top management time can be invested in taking an in-house function to world-class standards. Outsourcing allows an MTF to immediately realize the benefits of reengineering by having a private sector organization, one already reengineered to world-class standards, take over the activity. Private sector organizations often outsource the function to a contractor that can immediately provide the improvements offered by reengineering and assume the risks. This allows the MTF to realize the benefits of the reengineered activity in a timely manner.

d. *Share Risks*

Risks are inherent with the budget decisions an MTF Commander makes. Outsourcing permits MTFs to become more flexible to meet changing mission and other readiness requirements. It is also a tool for sharing risks with the private sector. Contractors make investment decisions that serve the entire range of customers. By sharing these investments, the risks to any single organization are reduced. The result is MTFs reduce risk and are better able to change to meet changing mission and operational requirements.

e. *Free Resources for Other Purposes*

Every MTF has limited resources. The challenge is to ensure these limited resources are employed in the most valuable functions. Outsourcing permits an MTF to redirect its in-house resources from non-core activities toward activities directly associated with maintaining skills necessary to support war time and other readiness requirements.

f. *Make Capital Funds Available*

Outsourcing is a way to reduce the need to use funds for non-core functions. These costs are often more difficult to justify compared to costs directly related to the mission. Through outsourcing, non-core functions can be contracted for on an "as used" basis, often at a lower cost than in-house performance. This makes funds available for core activities and modernization efforts.

g. *Cash Infusion*

Outsourcing can involve transfer of assets from the MTF to the contractor. Equipment, facilities, and vehicles used in current operations all have a value and can be sold to the contractor who then

uses these assets to provide services to the MTF and perhaps to other customers. Depending on the value of the assets, this sale may result in a significant cash inflow to the government. This contributes to federal budget deficit and debt reduction efforts.

h. Reduce and Control Costs

The economic environment has changed rapidly in the past several years making the U.S. government cost-sensitive. Today, the focus is to work more productively with fewer resources while further reducing the size and cost of the DoD infrastructure. MTFs, specifically, have been targeted for cost reductions and cost containment.

The most common reason for outsourcing is to reduce and control costs. Outsourcing provides access to the contractor's lower cost structure that results from a greater economy of scale or specialization. Additionally, hospitals that try to do everything internally may incur higher overall costs. These costs are ultimately passed on to tax payers. Tax payers, however, are too sophisticated to accept costs associated with government's traditional attempt to maintain centralized control over all its resources. Outsourcing allows MTFs to improve efficiency and effectiveness at a lower cost to tax payers.

Outsourcing also provides MTFs ability to account for costs. It remains difficult to account for all costs of an in-house provided function because certain portions of functions have hidden costs. Contractor costs, on the other hand, are fully accounted for through internal financial management controls and represent all the costs for

service delivery. Knowledge of costs may lead MTFs to streamline functions to reduce and control or eliminate costs.

Competition, a component of outsourcing, contributes to cost minimization and greater efficiency, regardless of who performs the function. It forces MTF managers and personnel to look at the processes and costs associated with the function, revealing the hidden costs of the function. In fact, MTF personnel may gain sufficient knowledge from the competition process to become economically efficient to compete with the private sector and win the bid. If in-house personnel win the competition, then a Memorandum of Understanding (MOU) should be implemented to outline the performance standards expected from in-house personnel. The MOU should also include a statement that the function will be competed again in the future. This promotes continuous effort to improve performance and reduce the cost of in-house performance. It also provides an opportunity to evaluate the function and ask, is it value added? Some functions may longer be necessary to perform.

i. Resources Not Available Internally

Many MTFs outsource because in-house resources are not available. For example, if an MTF is expanding its operations, outsourcing is a viable and important alternative to acquiring the in-house resources needed to meet the requirement. Perhaps military personnel downsizing and civil service hiring freezes have shrunk the size of the work force, BRACs have reduced the MTF infrastructure, or budget reductions have divested the MTF of financial resources necessary for in-house performance. In these cases, outsourcing provides the opportunity to continue providing a service or expand service delivery

without further depleting in-house resources. Similarly, new requirements indicate that outsourcing is necessary. OMB Circular A-76 encourages new requirements to be outsourced. For example, child care is increasingly being added to MTFs, yet in-house resources are limited and needed for mission essential purposes. Outsourcing permits MTFs to provide child care services without shifting in-house personnel away from mission essential activities.

Another resource that may not be available in-house is technology. For example, in-house technology may not sufficiently support the size of patients records management yet private sector firms specialize in this area. Contracting out patient records management provides MTFs with access to the latest technology used to provide this support service without directly funding all the changes in technology necessary to maintain a state-of-the-art system. Outsourcing this service can increase reliability and consistency of service delivery.

An MTF with rapidly changing requirements may not be able to respond to changing demands on in-house resources. Contractors can rapidly provide personnel and other resources to augment or replace in-house resource requirements.

j. Function Difficult to Manage or Out of Control

This is often perceived as an advantage but this is actually a disadvantage. If a function is viewed as difficult to manage or out of control, MTF management needs to examine the causes. If, for example, the reason is that the requirements, expectations, or needed resources are not clearly understood, then outsourcing will not improve

the situation. It may make it worse. If the real problem is that the MTF does not understand the requirements then it will not be able to communicate them to a contractor.

4. Why Make-or-Buy Analysis is Important to Making Good Decisions

The importance of the make-or-buy decision is attributed to the impact the decision can have on MTF operations. The decision of whether to provide a service in-house or buy the service from a commercial source can have a significant impact on the day-to-day and long-term operations of the MTF. It can be an effective tool to increase, decrease, or maintain hospital work force level and a means to control increasing costs of providing a good or service. The decision to provide a good or service with in-house or commercially available resources can be applied to commercial activities, such as laundry, dry cleaning, child care, ADP, and pest control. Make-or-buy decisions can also be applied to supplies, medical services and procedures, hospital administration, laboratory tests, staffing requirements, and new equipment.

Individually, make-or-buy decisions may not significantly impact the overall operations of the hospital. In the long-run, however, these decisions can effect hospital capacity, business practices and processes, and funding. Collectively, the savings achieved by MTFs from outsourcing contribute to federal budget reduction and DoD modernization efforts.

The objective of make-or-buy decisions should be to find the best use of the hospital's personnel, equipment, and budget dollars. Make-or-buy analysis, however, is a complex process. Decision makers must

consider both financial (quantitative) and non-financial (qualitative) factors. Quantitative factors include the cost of providing the good or service. Qualitative factors include quality requirements, contractor relations, and work force stability. Factors important in making one decision may be more or less important in making another decision. Therefore, the potential impact of all factors in the decision should be considered because changes in technology, demand, and capacity can make today's good decision a bad one tomorrow.

Goals should be established and the mission should be reviewed. For instance, the DoD encourages outsourcing to become more efficient, effective, and economical. In short, MTFs are urged to: reduce personnel, equipment, and facilities to achieve infrastructure reductions; reduce costs and thereby increase savings to support modernization efforts; and introduce streamlined business practices to increase productivity. To achieve these goals, the DoD tends toward the buy decision. If DoD were in a growth period, decision makers may prefer the make alternative because this makes use of in-house resources and minimizes unemployment of personnel. The make-or-buy decision should support the goals and mission to be achieved. Outsourcing, however, is not the sole alternative and should be implemented only when appropriate. This is why make-or-buy cost comparisons are conducted, to determine which alternative provides the best use of resources.

G. ADVANTAGES AND DISADVANTAGES OF OUTSOURCING

The MTF task is to select a contractor that can maximize the advantages and minimize the disadvantages associated with outsourcing.

1. Advantages

The following section identifies several advantages of outsourcing. Advantages discussed are not all inclusive.

a. Control Costs

Outsourcing reduces infrastructure costs, capital expenditures, and maintenance costs of performing commercial activities. These reductions are necessary to improve efficiency. Even when the service is retained in-house, competition of the service results in average cost savings of 20%.

b. Competitive Forces

Competition drives MTFs to improve quality, increase efficiency, reduce costs, and focus on patients. It can also lead to more rapid delivery of better products and services to warfighters, thereby increasing readiness.

c. Flexibility

Outsourcing provides managers with flexibility to determine the appropriate size and composition of the resources needed to complete tasks as requirements change. In addition, it is easy to increase services or terminate contracts as demand decreases or disappears.

d. Economies of Scale

Contractors that specialize in specific services generate a relatively larger volume. This allows them to take advantage of economies of scale. Often, these economies of scale mean that specialized service contractors can install, operate, manage, and maintain state-of-the-art systems more cost effectively than the MTF. Outsourcing provides a means for the government to take advantage of

experience and technologies MTFs cannot acquire or operate economically. This translates in reduced capital expenditures for MTFs that take advantage of the contractor's investment in the latest technology.

Finally, when a new requirement is outsourced, the MTF can take advantage of contractor experience, knowledge, training, and management processes to quickly implement a service that a less experienced in-house staff may take months or years to develop.

e. Better Management Focus

In recent years, successful private companies have focused on their core competencies, those activities that give them the competitive edge, and outsourced support activities. Outsourced activities have remained important to success but are not core to the organization's mission.

Business analysts consider organization leaders' time a scarce resource that should be allocated wisely. Likewise, outsourcing allows staff personnel to concentrate on performing activities that directly impact the mission. This is equally true for the DoD. Outsourcing allows MTF managers to focus on improving quality, responsiveness, and efficiency while lowering costs of performing core activities.

f. Better Business Practices

Often, the contractor's business is to deliver world-class support service to customers. As a result, contractors that specialize in providing support services, such as laundry, food, or ADP services, have proven experience and leadership in applying their specialty to the process. Furthermore, contractors have access to industry knowledge and

practices that can be used at the MTF. Time and money otherwise spent on training in-house personnel can be saved. An added advantage is the contractor's world-class abilities enable consistent quality of services or products to be provided to the MTF.

g. Cost Visibility

Outsourcing helps MTFs identify personnel, capital, and equipment costs. Historically, DoD and MTF accounting systems have been inadequate to provide the cost information needed to identify the cost of performing a function. Many in-house functions have hidden costs that do not readily appear in an accounting system. When the function is outsourced, it may seem more expensive because previously hidden costs are accounted for through contractor accounting and reporting systems. Outsourcing provides a tool for focusing on and identifying costs relevant to the performance of activities. When these costs are appropriately identified, strategies and benchmarks can be developed to effectively, efficiently, and economically improve work processes and further reduce costs.

h. Reduced Labor Costs

Typically, contractors employ fewer personnel to provide the commercial activities previously performed by in-house personnel. Additionally, in-house staff is often reduced as a result of outsourcing. This translates into MTFs being able to reduce or remain within FTE limits.

i. Reduce Contracting Costs

An MTF can regionally contract out support services and thereby reduce the number of contracts to manage. This translates into

lower overhead costs because fewer Contracting Officers and Program Managers are needed to oversee the contract. This also allows standardization of contracting procedures.

2. Disadvantages

An evaluation of advantages should accompany an assessment of the disadvantages. Accordingly, the following disadvantages offer an overview of some potential pitfalls of outsourcing.

a. Quality Can Suffer

Problems that arise in this area are generally caused by poorly specified PWS. Therefore, MTF Commanders and Comptrollers should coordinate with the Procurement and Contracting Officers to develop detailed descriptions of the type, quality, quantity, and timeliness of the work to be performed. Attention should be given to the PWS to: identify quality requirements in the Statement of Work and/or PWS, accept the bidder that offers the best value for the service being provided, and incorporate performance measures into the contract to enable regular evaluations of contractor performance. If discrepancies in performance are detected early, adjustments can be made to improve the quality of the service provided.

b. Prices May Rise

Contractors may submit low bids then, once the contract is awarded, increase prices. This can be avoided if sufficient consideration is given to: use of a fixed price contract, or a contract with incentives for the contractor to keep costs down and quality up; specify the tasks and services to be performed, how and when they should be performed in the Statement of Work or PWS; specify in the contract

the conditions that must exist before price increases will be accepted. One additional method to avoid price increases is to be alert to prices of similar services within the public and private industry. This can be accomplished by surveying contractor prices, reviewing industry price lists, or reading industry literature that quote prices.

c. Once a Function is Outsourced, It Can Be Difficult to Convert It Back In-House

National defense requirements may increase resulting in the need to expand in-house capacity to respond to the threat environment. This in turn, may generate the need to reduce the amount of work that is outsourced and increase the amount of work performed in-house. Federal procurement systems are in place to address this situation. During a crisis that requires rapid expansion of capabilities, contractors and reserve forces provide the services necessary to support national defense efforts.

d. Control

While MTF Commanders and staff personnel will give up control of the daily operation of the support service formerly performed in-house, control will still be maintained at the oversight level. Control over the outsourced service can be assured by preparing a well-written Statement of Work or PWS that includes the content and frequency of status reports to the Contracting Officer or Program Manager that manages contract performance. Another option is partnering. Sit down with the contractor, state the service that is wanted, how and when the

service should be provided, then set mutual goals and objectives. This gives the contractor a vested interest in the work performed and places the MTF in control.

*e. **Make-or-Buy Cost Comparisons Take a Long Time***

Simplified cost conversions take 24 months on average to complete. Multiple cost comparisons take an average of 48 months to complete. This can create a disincentive to outsource. However, the OMB Circular was recently revised, making it possible to complete cost comparisons in about twelve months.

*f. **Dislocated In-House Personnel***

Many MTFs are reluctant to outsource because it often involves laying off civil service personnel. The good news is programs are in place to move these personnel to core activities within the MTF, provide "first right of refusal" to work for the contractor, or obtain employment elsewhere. Agreed, relocation of in-house personnel is difficult for MTF management and affected personnel. However, civil service employees often report satisfaction with the new arrangement, stating better career and training opportunities are available in the new job.

H. ALTERNATIVES

The decision to outsource or use alternative means to perform support activities needed to achieve the mission depends on the goals and priorities of the MTF. Many private firms concentrate in-house resources on core activities and outsource the rest. DoD agencies are doing the same. Nevertheless, alternative sources are available for achieving the desired goal. MTFs can increase military and civil

service billet authorizations, employ temporary additional duty or reserve personnel, lease, maintain the status quo, avoid new requirements, eliminate the requirement, or use inter- or intra- service agreements (ISSA).

1. Increase Military Billet Authorization

This option provides a permanent and long-term solution to personnel staffing shortages. It also provides the consistency in performance many agencies desire. It is, however, unlikely to be approved during phases of downsizing, BRACs, or budget reductions.

2. Increase Civilian Billet Authorization

This alternative provides a permanent solution to personnel shortages and provides consistency in the type and quality of work performed. These requests, however, will unlikely be approved during hiring freezes, BRAC phases, or budget reductions.

3. Temporary Additional Duty (TAD) or Reserve Personnel

When the intent is to temporarily augment a change in operating requirements, this may be a viable option. MTF Commanders should keep in mind that TAD and reserve personnel must eventually be returned to parent organizations. In addition, requests for TAD personnel may be denied if this will cause the TAD provider to become short-handed.

4. Lease

Leasing reduces the requirement for large in-house expenditures of personnel, plant, and equipment. Leasing is desirable when Procurement funds are not available to buy equipment. With leases, Operations and Maintenance funds may be used.

Maintenance and repair services can be provided by the lessor at no additional charge. If desired, these services should be included in the lease agreement. Including these services in the lease saves MTFs the costs of training and compensating in-house personnel to perform them.

An MTF can use leasing to become more flexible and to rapidly adapt to changing mission and readiness requirements. For example, if technology for CT scanners is fluid, with new versions of this equipment being introduced every three years that make the equipment more cost effective and efficient, then leasing may be the preferred option. Leasing, in this case, enables the MTF to take advantage of emerging technology without the funding required to buy, repair, and maintain the equipment.

It can, however, cost more than the buy alternative. Therefore, a cost analysis of the equipment life cycle costs should be prepared to determine whether to lease or buy. Ensure all costs incurred from the lease are written in the lease agreement, including maintenance and repair.

As with outsourcing, the lessor company will accommodate requests for upgrades or downgrades in equipment as long as an appropriate amount of notice is given. If desired, this option should be included in the lease agreement. Notification requirements are usually specified in the lease agreement. These agreements can be renewed periodically. At termination of the lease, the equipment is returned to the lessor.

5. Status Quo

An MTF Commander should consider whether the service is being performed cost effectively and efficiently and whether performance of the service directly impacts the mission. If the answers are yes, then the service should continue to be performed by the current in-house or by contractor provider.

6. Avoid New Business

The OMB Circular A-76 states that new requirements should be contracted out unless contract prices or quality of contract performance are believed to be unreasonable. Otherwise, new requirements, such as child care, can be outsourced directly.

7. Eliminate the Requirement

Some services may no longer be necessary to perform. The MTF Commander can determine whether or not the hospital should be in the business of providing a particular service by asking if the service adds value to the MTF mission. If responses are negative and there is no compelling reason to continue providing the service, then the MTF should eliminate it.

8. Inter- or Intra- Service Support Agreement (ISSA)

An ISSA is an attractive alternative when a new or expanded service is involved. OMB Circular A-76 permits ISSAs when excess property and common administrative services are available from other federal agencies and when the service can be provided more economically than through a commercial source.

As with outsourcing and leasing decisions, ISSAs require a cost comparison. The cost comparison procedures are similar to those for outsourcing and are outlined in OMB Circular A-76.

9. Summary

The MTF Commander can make short-term or the long-term resource management decisions. Short-term decisions include use of TAD or reserve personnel, leases, maintain the status quo, stay out of new business, outsource, eliminate the requirement, or implement an ISSA. Long-term decisions include outsourcing, leasing, adding military or civilian billets, maintaining status quo, and adding, expanding, or deleting a service. Selecting the best alternative requires analysis of the goals and mission to be achieved to determine the best mix of resources to use to achieve the desired outcome.

III. WHAT DATA HAVE BEEN USED IN MAKE-OR-BUY ANALYSES?

A. NAVAL MEDICAL CENTER SAN DIEGO

Make-or-buy cost comparisons are increasing in use as the DoD expands the use of outsourcing to achieve greater efficiency and cost effectiveness. An assessment of three make-or-buy cost studies conducted by Naval Medical Center San Diego provides an example of simplified cost comparisons, which criteria and variables are used to form make-or-buy decisions, some advantages and disadvantages of contracting out services, and lessons learned from these outsourcing initiatives.

1. Background

Naval Medical Center San Diego is the largest Naval medical teaching facility on the West Coast. It is operated by 3,300 military and 1,200 civilian health care and administration personnel to serve nine Naval and Marine Corps installations and 70 ships located and homeported in the San Diego area. In sum, the Naval Medical Center provides health care services to 450,000 active duty, retired, and family member personnel.

The medical center mission is, "to provide a comprehensive range of health care services to active duty Navy, Marine Corps, and other Uniformed Service personnel." The mission is also to:

- Ensure that all assigned personnel are aware of and trained to properly perform assigned contingency and war time duties;
- Prepare for the proper state of readiness to meet contingency and war time mission requirements;
- Provide, as directed, health care service support to Navy, Marine Corps, and Operating Forces operations;

- Provide, as availability of space and resources permit, health care services to personnel entitled under Title 10, U.S. Code, and other applicable directives;
- Administer education programs for military personnel to ensure both military and health care standards are achieved and maintained;
- Conduct graduate and post-graduate education programs for medical students and medical department officers;
- Participate as an integral element of the Navy and Tri-Service Regional Health Care System;
- Cooperate with military and civilian authorities in matters pertaining to public health, local disasters, and other emergencies; and
- Maintain quality health care standards to ensure successful accreditation and recognition by appropriate government and civilian agencies to include the Joint Commission for Accreditation of Healthcare Organizations (JCAHO).²⁵

Achieving this mission entails provision of graduate education programs, award of fellowships, affiliation with local universities and research foundations, and coordination with foundations nationwide to enable trainees to perform duties as residency and fellowship students. Naval Medical Center San Diego also operates a network of clinics located at military installations in the San Diego area. Emergency and ambulatory care are provided through these clinics to all active duty personnel stationed at sea and shore commands based in San Diego. Finally, the Naval Medical Center deploys five mobilization teams and two fleet surgical teams using hospital personnel. These teams deploy to the Western Pacific and Southeast Asia at various times throughout

²⁵Naval Medical Center San Diego, *Efficiency Review Report* (California: Naval Medical Center San Diego, 1996) 7.

the year. Each time a ship goes to sea, health care professionals also deploy to ensure personnel aboard Naval ships have access to quality health care.

2. The Outsourcing Initiative

In September 1995, the ESC, composed of the Commanding Officer, Executive Officer, directors, and senior enlisted advisor, directed the Naval Medical Center to reduce operating costs by conducting commercial activities cost comparisons for custodial, child care, and food services. These services were to be contracted out provided the cost of performing these services would be reduced by doing so. Based on the cost comparisons, costs would be reduced by contracting them out; therefore, all three activities have been outsourced. In the interest of brevity, food service will be the primary focus of the discussion that follows.

The food service cost comparison process provides an example of the timeline to prepare the cost study and start the contract. A simplified cost comparison was completed for the food service activity in one day. The Commanding Officer reviewed the cost study, approved and signed the document, and forwarded the cost study to BUMED for approval. After BUMED approved the cost study, it was forwarded to the DCNO for Logistics (N-443) for final approval. This signature process took one month to complete. A fixed price contract and PWS were then prepared. The Commanding Officer, Comptroller, and Food Service Director coordinated efforts to develop and prepare the PWS. In total, the cost study, PWS, and contract initiation processes were completed in 13 months.

In October 1996, contract personnel replaced 33 in-house civilian employees to provide food service. These personnel are responsible for: cleanliness of facilities, equipment, and utensils; preparation of food by performing tasks, such as washing, trimming, peeling, shredding, and dicing food either manually or mechanically; performance of food production tasks, as necessary; and attendance of food areas, such as the salad room, dessert room, central tray room, scullery, and dock area. Dietician, nutritionist, and cooking services are performed by in-house personnel as these activities are deemed necessary for career progression and sea-shore rotation of the military personnel filling these positions.

3. Criteria Used to Evaluate the Make-or-Buy Decision

The make-or-buy decision for all three activities was driven primarily by cost. When the cost study was completed, the minimum threshold cost differential of ten percent of in-house personnel costs required in OMB Circular A-76 was met and the decision was made to outsource all three activities. Secondary criteria for outsourcing food service included: ability to remain within FTE limits, ability of the contractor to meet the threshold quality level of food service delivery required by governmental and health service standards, flexibility of the contractor to meet demand for the number of meals served, ESC support, ability to forego the competition process and pursue service delivery from the same contractor that performed scullery services, the current contractor understood the MTF culture, in-house personnel already work with contracted scullery personnel, convenience of retaining food service in the medical center, and familiarity with the

contractor. In addition, an on-site manager would be provided by the contractor to supervise the food servers. Since food service would be provided at the medical center, equipment would be government furnished. Finally, cleaning supplies, sanitary gloves, and uniforms would be furnished by the contractor. Coupled with the lower contractor costs to perform food service, these criteria were all favorable to the outsourcing decision. The Commanding Officer therefore decided to contract out food service.

4. Variables Considered to Form the Make-or-Buy Decision

Since cost was the driving factor in forming the make-or-buy decision for all three activities, personnel wage and benefits costs were the primary variables considered. For all three activities, the decision to outsource was formed as the result of potential contractor ability to provide the services at lower cost and higher quality than was possible by in-house performance.

B. RELEVANT QUANTITATIVE COSTS

Custodial, child care, and food service each met the criteria for conducting a simplified cost comparison. Specifically, each employed 65 or fewer FTEs, these activities were competed based on labor and supplies, and all equipment requirements would be furnished by the government since contract personnel would work at the medical center. Therefore, a simplified rather than a full cost comparison was completed for each activity. The cost comparisons on the following two pages display the in-house and contractor cost estimates for the three services outsourced by Naval Medical Center San Diego. Components of the annual in-house personnel costs include: base wage (calculated by

wage grade and step), overtime and holiday pay, fringe basic and medical benefits, federal and state withholding taxes, and retirement program benefits. Other in-house costs include cost of uniforms.

Food Service

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$909,952
Other In-House Costs (Uniforms)	<u>3,300</u>
Total Estimated In-House Cost	<u>\$913,252</u>

Contractor Cost Comparison:

Estimated Contract Price	\$599,998
Contract Administration (if appropriate)	0
Other Estimated Contract Cost (Uniforms)	<u>3,300</u>
Estimated Contract Cost	\$603,298*
10% of Government Cost	<u>90,995</u>
Total Estimated Contract Cost	<u>\$694,293*</u>
Less Total Estimated In-House Cost	<u>913,252</u>
+ Retain In-House/ - Contract Out	- <u>\$218,959</u>

Custodial Services

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$977,469
Other In-House Costs (Uniforms)	<u>3,600</u>
Total Estimated In-House Cost	<u>\$981,069</u>

Contractor Cost Comparison:

Estimated Contract Cost	\$660,517
Contract Administration (if Appropriate)	0
Other Estimated Contract Costs (Uniforms)	<u>3,600</u>
Estimated Contract Cost	\$664,117
10% of Government Cost	<u>97,747*</u>
Total Estimated Contract Cost	<u>\$761,864*</u>
Less Total Estimated In-House Cost	<u>981,069</u>
+ Retain In-House/ - Contract Out	- <u>\$219,205</u>

Child Care

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$580,714
Other In-House Cost (Non-Appropriated Funds)	<u>196,788</u>
Total In-House Personnel Costs	\$777,502*
Less Bureau of Naval Personnel (BUPERS)	
Fees Collected	<u>287,282</u>
Total Estimated In-House Cost	<u>\$490,220*</u>

Contractor Cost Comparison:

Estimated Contract Price	\$509,903
Contract Administration Cost (if Appropriate)	0
Other Estimated Contract Cost	<u>0</u>
Estimated Contract Cost	\$509,903
Less BUPERS Fees Collected	<u>287,282</u>
Estimated Contract Cost	\$222,621*
10% of Government Cost	<u>77,750*</u>
Total Estimated Contractor Cost	\$300,371*²⁶
Less Total Estimated In-House Cost	<u>490,220</u>
+ Retain In-House/ - Contract Out	- <u>189,849</u>

Figure 2 Commercial Activities

Cost Comparisons

Source Adapted from Naval

Medical Center San Diego

Commercial Activities

Cost Comparisons

C. RELEVANT QUALITATIVE COSTS

At this medical center, contract food servers only serve meals to medical center personnel, patients, and visitors who dine in the cafeteria. Food is not served by contract personnel to staff, patients, or visitors outside of the cafeteria. In-house personnel serve food to patients wards.

So far, background and cost comparison information have been discussed for food, custodial, and child care services. Next,

²⁶A * denotes an adjustment has been made to correct the original calculation.

advantages and disadvantages for food service are discussed, although these are also applicable to custodial services and child care.

D. ADVANTAGES AND DISADVANTAGES OF OUTSOURCING

An advantage of contracting out food service is contractor personnel can be held to higher performance standards than in-house personnel. The Food Service Director simply highlights the performance requirements listed in the PWS to obtain compliance from contract personnel. Since contractors and contractor personnel know that non-compliance with the PWS may be grounds for contract termination based on non-performance, tasks are usually performed according to work specifications. In the event a contractor's failure to perform results in an attempt by the MTF to end the outsourcing arrangement, successful contract termination can occur immediately.

In-house personnel, on the other hand, are not employed by contract. Furthermore, in-house personnel understand the complexity of actions required to terminate them. Provided that an in-house employee is unable or unwilling to improve performance, attempts to terminate the in-house employee are complex and lengthy, often taking two or more years to complete. The process includes employee notification of the performance discrepancy, documentation of the unsatisfactory performance, managerial visits to the Human Relations Office (HRO) to receive guidance on how to appropriately resolve the problem, employee training, and so on. After efforts have been exhausted to provide the in-house employee every opportunity to improve performance, termination may finally take place. Compared to the time necessary to terminate a contract, in-house employee termination is a much longer process.

Another advantage of outsourcing food service is contracting out permits Naval Medical Center San Diego to stay within FTE limits. This advantage is commonly cited by both public and private hospitals.

A disadvantage of outsourcing includes decreased morale of replaced and remaining in-house personnel. Despite collaborative efforts of the human resources and food service departments at the Naval Medical Center San Diego to implement a well-organized transition plan, affected personnel were naturally disgruntled about being replaced by contract personnel. In addition, remaining in-house personnel had difficulty facing the loss of relocated co-workers.

As mentioned in the previous chapter, military commands that initiate outsourcing will often attempt to relocate affected personnel elsewhere in the command, with the contractor under the "first right of refusal" contract clause, or through early retirement. Since severance pay and unemployment compensation expenses may be very high and Reductions in Forces (RIF) require Office of Personnel Management (OPM) approval, military commands tend to implement RIFs as a last resort. At this medical center, affected personnel were not able to be relocated elsewhere in the command, to be hired by the contractor, or to be retired early. The only remaining alternative was to initiate a RIF. This entailed large payments of unemployment compensation, severance pay, workman's compensation, retirement, and early retirement to relocated personnel. Despite this costly procedure, long term savings, or costs avoided, in payroll and supplies have been estimated to be \$310,000 (rounded) per year, significant enough to warrant outsourcing.

Another disadvantage is the time required to implement changes to performance requirements. For example, when the Food Service Director identifies a discrepancy in food server performance, the Director must notify the on-site manager and/or the Contracting Officer to resolve it. Until contract personnel are formally notified, the performance discrepancies continue. This process can take from ten minutes up to one week to complete. Time consumed to implement these changes is dependant upon the availability of personnel who have authority to implement the required change, and also upon the complexity of the discrepancy.

E. LESSONS LEARNED

The following section describes lessons learned from Naval Medical Center San Diego. These lessons provide an overview of experienced gained from the food service outsourcing initiative.

1. Communication

The primary lesson is to get departments responsible for implementing the outsourcing initiative together as a team early in the process. Contracting personnel and department heads (i.e., functional experts) of activities to be outsourced should communicate with each other and work together to develop and prepare a clear and specific PWS. Spending the time to develop well-defined specifications should reduce or eliminate the time required to implement major or frequent changes after contract award and thereby reduce modification costs.

2. Identification of Contractor Tasks

The functional expert of the outsourced activity should conduct research to identify all tasks and duties the contractor will need to

perform. This food service contract was modified each time additional performance requirements were identified. As contract performance continued, the Food Service Director identified performance discrepancies in food preparation that needed correction through training. Although the contractor has performed work under military contract before, the contractor was not familiar with military hospital food service standards. As a result, contract personnel completed training in food preparation to meet governmental and health care guidelines. Fortunately, no additional contract costs were incurred because training costs had been included in the contract price.

3. Build a Relationship with the Contractor and Contract Personnel

Although government contracts require periodic meetings between in-house and contract personnel to build working relationships, a lot of on-the-job time is also required to establish trust in the relationship. At the medical center, in-house personnel initially did not want to work with contract food service personnel despite the existing relationship with the contract scullery workers. Meanwhile, contract food service personnel attempted to perform tasks beyond the scope of the contract, at an additional charge. For example, one contract food server offered to deliver food carts to patient wards. Another offered to help prepare the current meal according to the recipe. While these offers may have been well-intended, actual performance of these tasks would have led to contractor performance beyond the scope of the PWS. Tasks performed beyond the scope of the PWS potentially increase the cost of contract service delivery. Since these tasks are not included in the PWS, the contractor food servers were not permitted to perform them.

Eventually, MTF leadership was necessary to bind the two groups of personnel together as a team and to focus each group on performance of assigned duties. The Food Service Director ultimately designed and implemented a civilian, military, and contractor "Employee of the Quarter" program to ensure one person from each group was recognized for excellence each quarter. This built morale and improved relations among the three groups of personnel in the cafeteria.

F. FUTURE OUTSOURCING PLANS

The CNO message, date-time-group 082326Z JAN 97, directed the medical center to complete cost comparisons for child care and ADP. Child care was already contracted out in 1996. Therefore, a cost comparison will be completed only for ADP to determine whether this activity should be performed in-house or by contract.

G. BACKGROUND ON THE CONTRACTOR

Food and scullery services are the core business of the contractor performing these services at the medical center. Although the contractor did not wish to be identified, it is reputed to be the best in the San Diego area.

H. RELEVANT QUANTITATIVE COSTS

The estimated contract price for each of the three outsourced activities is composed of annual personnel costs that include: base pay, fringe benefits, overtime and holiday pay, fringe benefits, federal and state withholding taxes, retirement program benefits, and workman's compensation. Other estimated contract costs include the cost of uniforms.

Contract administration costs are zero in the food service cost study because the medical center chose to use the option, available in OMB Circular A-76, to forego the bid process and to use the same contractor that performs scullery services. Therefore, contract administration costs have previously been accounted for in the original contract for scullery service and are not relevant to the food service make-or-buy decision. If the medical center had used the bid process, then contract administration costs would have been relevant to this decision.

In compliance with OMB Circular A-76, 10% of the in-house personnel cost is added to the estimated contract cost. As displayed in the condensed cost comparisons below, the total estimated in-house cost is then subtracted from this sum. The positive or negative result is used to form the decision to make or buy the service. A positive result favors in-house performance while a negative result favors contracting out. In each of the comparisons, the contract cost minus the in-house cost produces a negative result. Therefore, each activity was contracted out.

Food Service

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$909,952
Other In-House Costs (Uniforms)	<u>3,300</u>
Total Estimated In-House Cost	<u>\$913,252</u>

Contractor Cost Comparison:

Estimated Contract Cost	\$603,298*
10% of Government Cost	<u>90,995</u>
Total Estimated Contract Cost	<u>\$694,293*</u>
Less Total Estimated In-House Cost	<u>913,252</u>
+ Retain In-House/ - Contract Out	- <u>\$218,959</u>

Custodial Services

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$977,469
Other In-House Costs (Uniforms)	3,600
Total Estimated In-House Cost	<u>\$981,069</u>

Contractor Cost Comparison:

Estimated Contract Cost	\$664,117
10% of Government Cost	<u>97,747*</u>
Total Estimated Contract Cost	<u>\$761,864*</u>
Less Total Estimated In-House Cost	<u>981,069</u>
+ Retain In-House/ - Contract Out	- <u>\$219,205</u>

Child Care

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$580,714
Other In-House Cost (Non-Appropriated Funds)	<u>196,788</u>
Total In-House Personnel Costs	<u>\$777,502*</u>
Less BUPERS Fees Collected	<u>287,282</u>
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Less Total Estimated In-House Cost	<u>490,220</u>
+ Retain In-House/ - Contract Out	- <u>189,849</u>

Figure 3 Commercial Activities

Cost Comparisons

Source Adapted from Naval

Medical Center San Diego

Commercial Activities

Cost Comparisons

As mentioned above, the positive or negative result is used to form the decision to make or buy the service. For example, the food service result is - \$218,959. This does not indicate the cost savings to be achieved from performing the service in-house or by contract. Separate calculations are necessary to identify the cost savings projected by shifting from or to in-house or contract performance.

Cost savings are calculated by summing the avoidable and incremental costs of performing the service. As will be seen, this is not an easy task. Recall that avoidable costs are those that go away as a result of the make-or-buy decision while incremental costs are those that change as a result of the decision.

The concept is to identify costs that truly go away or are reduced as the result of the make-or-buy decision. As shown in the cost comparison on the next page, the decision to outsource food service causes the in-house food server payroll costs, \$909,952, to go away. Likewise, the \$3,300 cost of in-house food service uniforms goes away when food service is outsourced. These are avoidable costs. However, most of the in-house personnel payroll costs and all of the uniform costs are simply shifted to the contractor as contract personnel labor and uniform costs. Uniform costs do not generate a savings as the cost is \$3,300 whether the medical center pays the in-house cost or pays the contractor for the cost of these uniforms. Since the uniform cost is the same either way, these costs are not relevant to this cost savings calculation. Incremental cost calculations are necessary to determine which portion of the avoidable in-house payroll costs represent cost savings.

For food service at Naval Medical Center San Diego, the incremental cost is the negative change, or reduction, of contract labor costs relative to in-house personnel costs. The cost savings from outsourcing food service are calculated as the difference between the in-house and contract personnel costs. Subtracting in-house personnel costs, \$909,952, from contractor labor costs, \$599,998, generates annual

food service cost savings of \$309,954. This is nearly a \$100,000 improvement from the \$218,959 figure used to form the make-or-buy decision. If the \$218,959 result is erroneously used as the potential estimated cost savings from outsourcing food service, the savings will be underestimated.

Food Service

In-House Cost Comparison:

Personnel Cost	
(APF Funds, Including Fringe Benefits)	\$909,952
Other In-House Costs (Uniforms)	<u>3,300</u>
Total Estimated In-House Cost	<u>\$913,252</u>

Contractor Cost Comparison:

Estimated Contract Price	\$599,998
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Total Estimated Contract Cost	<u>\$694,293*</u>
Less Total Estimated In-House Cost	<u>913,252</u>
+ Retain In-House/ - Contract Out	- <u>\$218,959</u>

Figure 4 Commercial Activities

Cost Comparisons

Source Adapted from Naval

Medical Center San Diego

Commercial Activities

Cost Comparisons

I. RELEVANT QUALITATIVE COSTS

The contractor considered it possible to comply with governmental and health care standards within a reasonable price acceptable to the MTF. Training personnel to meet these standards was considered a negligible cost since the contractor had previous experience performing food services for the government.

J. SUMMARY

This chapter has summarized the data, criteria, and variables used by Naval Medical Center San Diego to evaluate and form make-or-buy

decisions. In addition, this chapter has described the advantages, disadvantages, and lessons learned experienced by Naval Medical Center San Diego during make-or-buy decision making and contract implementation processes. Chapter IV applies the information covered in this chapter to potential outsourcing initiatives at other MTFs and reveals lessons learned from both public and private industry.

IV. WHAT ARE THE CHARACTERISTICS OF MAKE-OR-BUY ANALYSES?

A. FOOD SERVICE

1. Outputs and Costs Are Identifiable

The make-or-buy cost comparison for food services, as described in the previous chapter, can be relatively easy to conduct at other MTFs because this activity has a tangible output, such as number of meals served. Once the output is identified, measuring costs is a matter of tracing the steps necessary to produce the output and identifying the cost of inputs consumed to produce that output.

Cost of food service may also be measured by outcomes. This is achieved by conducting surveys of personnel, patients, and visitors who dine in the cafeteria. The survey can be used to determine customer satisfaction, identify consumer preferences, and obtain an overview of demands for service relative to the current level of service. This information will help the MTF Commander to determine the inputs the MTF will use to measure costs. The next step is to trace the inputs and resulting costs to perform the determined level of service. This will provide a baseline against which contractor costs will be measured.

When calculating the cost to provide a service, be sure to account for the change in costs that may occur as a result of changes in volume of service delivery. For example, the in-house cost to serve 100 meals per day may be \$4 per meal. When the number of meals served increases to 200 meals per day, the cost per meal may be \$3. Ignoring the changes in costs that result from changes in volume will result in overestimated in-house costs. This may cause in-house cost estimates to compare

unfavorably with contractor cost estimates for providing the service. If the service is contracted out, this will cause projected cost savings to be lower than actual cost savings.

The next step is to calculate any costs that change as a result of the outsourcing decision, such as the cost of labor currently used to perform the service. The sum of these costs are then compared to the sum of contractor cost estimates, contract administration costs, and one-time contract conversion costs. The decision to make or buy should be based on the alternative that offers the lowest overall cost to provide the service. However, the decision process does not end here, performance, quality, and other criteria and variables must also be considered.

2. Performance and Quality Are Measurable

Measurement of food server performance is relatively easy because either the appropriate number of meals are served or not. Quality measurement, on the other hand, is more difficult in that quality is not a tangible output for many activities. After all, how should food quality be measured? Commanding Officers, Contracting Officers, and functional experts may find that considerable time is required to specifically identify quality measurements for most commercially available activities.

Quality standards that meet federal, health care, and other guidelines for food service in hospitals can be readily ascertained from instructions and regulations. The difficulty in quality measurement stems from quality factors, such as responsiveness of food servers to customer requests, that go beyond these baseline measures.

To facilitate the quality measurement process, it is necessary to develop a Quality Assurance Surveillance Plan (QASP) to describe the quality level provided by the current method of service delivery, whether in-house or by contract, and how it will differ if services are converted from or to in-house or contract performance. For food service, quality may include such factors as cleanliness of dining equipment and facilities as well as responsiveness of food servers to customer requests for milk, salt, or catsup.

If quality will differ as a result of conversion to or from in-house service delivery, the reasons must be explained. The QASP also describes the method of quality inspection to be used to evaluate service delivery. For instance, the inspector may initially check salt and pepper shakers to ensure they are refilled after each meal. The concept is to develop a baseline against which contractor performance will be measured. Although the QASP is not included in the bidding process, its content may be incorporated into the PWS that in-house and potential contractors will use to develop bids.

Quality of food service may be measured by the number of complaints received or by surveys of personnel, patients, and visitors who dine in the cafeteria. The complaints and surveys can be used to determine customer satisfaction, identify consumer preferences, and obtain an overview of demands for service. This information will help the MTF Commander to determine the acceptable quality level the MTF will use to measure contractor quality. The next step is to trace the inputs

and resulting costs to deliver service at this quality level. Input and cost identification can then be used to develop the quality measurements for the contractor to meet or exceed.

One other option is to define the quality level currently provided, through step-by-step analysis or customer surveys. The current quality level can then be compared to the quality level of the best public or private organization in the industry to determine the inputs required to bring the service quality up to this level. Current measures of quality can be used as the threshold the contractor must meet. Meanwhile, the quality measurements of the "best in the business" can be used to define the quality level the contractor should strive to achieve. This latter method may be used provided it is cost effective, not cost prohibitive, for the in-house or contractor service provider to bring the quality level to world-class standards.

When the quality and performance data have been collected, the decision to make or buy should be based on the alternative that offers the best overall value as to quality and performance. Now that cost, quality, and performance have been considered, other criteria and variables should be considered to ensure an informed decision is made.

3. The Service Is a Support Activity

Although nutritionists and dieticians may disagree, food service is not the core business of an MTF. Nutritionists and dieticians claim food service is the core business of an MTF because in-patients require nourishment while in the hospital. In addition, certain groups of patients require a special diet. This is true. However, the primary business of the hospital is to provide health care service to patients.

These services may not include food service for each patient. Many patients visit the MTF on an outpatient basis and do not consume meals in the MTF. Furthermore, food service supports the mission of providing health care to patients. Food service, therefore, is an activity that can be outsourced to permit in-house focus to be directed toward mission essential activities.

For patients who require meals during an MTF visit, whether meals are served by in-house or contract personnel, the origin of the meal service should not concern patients or the MTF as long as the meals are fresh, tasteful, nutritious, and cost effective. As to freshness, the MTF can prepare the meals that contract personnel will serve, order the food for the contractor to prepare and serve, or specify the time frame by which the food must be prepared and served or thrown away.

Regarding the nutritional portion of food service, a San Francisco Bay Area hospital that has contracted out food service for over 25 years provides an example. Food service, for this hospital, entails food preparation (i.e., cooking) and delivery (i.e., trucks) by contract personnel. The contractor delivers meals to the hospital and 16 branch hospitals in the Bay Area region. At the hospital, contract personnel serve the food in the cafeteria while in-house personnel serve meals to patient wards.

This hospital uses in-house nutritionists to prepare meal menus and recipes. These menus and recipes are then forwarded to the contractor site for contract personnel to prepare according to recipe

and portion-size specifications. This process enables costs to be readily calculated by estimating the labor and other resources consumed in preparing these recipes.

Providing menus and recipes to the contractor should effectively reduce variation in the quantity and quality of each meal served. The danger is that the contractor may point to the in-house nutritionist as the source of deviation when discrepancies in meal quality are identified. Finger pointing can be prevented by using tried and true menus and recipes, previously tested in-house, for the contractor to prepare on a rotational basis.

The nutritionist of the San Francisco Bay Area hospital prepares six different menus, that cover a 30-day period, for each category of patients requiring special types of meals. For instance, six menus are prepared for the pediatric ward while six different menus are prepared for the geriatric ward. These two sets of menus are used on a rotating basis by the contractor. For example, menu one may be used during January while menu two is used in February, and so on until the sixth menu has been used. Six months later, or in June, menu one is used again. In this manner, familiarity with each recipe and portion-size requirements should reduce the potential for deviations in meal quality.

So far, output and cost identification have been applied to food service outsourcing decision. Performance and quality measurements have also been considered. In addition, food service has been justified as a support activity. Continuing the food service make-or-buy decision process, the focus shifts to other criteria and variables that drive the

decision process, although the criteria and variables are also applicable to custodial and child care services.

4. Other Criteria and Variables Used Drive the Decision

When food service is no longer performed by in-house personnel, the MTF benefits by gaining ability to focus in-house resources toward activities that directly effect the mission and readiness. Outsourcing also permits in-house resources to be shifted to provision of direct patient care. Another benefit is that outsourcing permits the MTF to remain within FTE limits.

Through contractor economies of scale, the MTF can keep food service costs down. In addition, the MTF can take advantage of contractor expertise, best business practices, and new technologies that potentially increase the quality of food service. Furthermore, top management is able to focus on mission, readiness, and direct patient care issues rather than provision of the food service, a support activity. Although attention will be directed toward provision of food service on occasion, this activity will not require the bulk of top management time.

Finally, stakeholders, such as, elected officials, BUMED, and patients should appreciate the cost reductions and service improvements resulting from outsourcing initiatives. Cumulated across many MTFs, significant cost reductions may be realized from outsourcing commercially available activities.

In summary, food service is a promising activity to contract out successfully because the output is tangible and costs are relatively easy to quantify. Furthermore, performance is measurable and quality is relatively easy to specify.

Now that costs, quality, performance, and other criteria and variables have been considered, the decision to make or buy the service can be made. The make-or-buy decision should be based on the alternative that meets or exceeds the PWS specifications at the best overall value to the MTF and its stakeholders.

B. CUSTODIAL SERVICE

1. Outputs and Costs Are Identifiable

As with food service, make-or-buy cost comparisons for custodial service can be relatively easy to conduct at other MTFs because this service has a tangible output, such as, square feet cleaned. Once the output is identified, measuring costs is a matter of performing the same steps as described for food service. The sum of the in-house costs are then compared to the sum of contractor cost estimates, contract administration costs, and one-time contract conversion costs. The decision to make or buy should then be made based on the alternative that offers lowest overall cost to provide the service.

2. Performance and Quality Are Measurable

Performance measurements for custodial services are relatively easy because either the appropriate number of square feet are cleaned or not. Quality measurement, as previously mentioned, is more difficult to measure in that quality is not a tangible output for many activities. How should quality of cleanliness be measured? Considerable time may be

required to identify quality measurements. Fortunately, solutions for measuring quality are the same as those mentioned for food service. Again, the decision to make or buy the service should be based on the cost, quality, performance, and other criteria and variables considered. The alternative to select is the one that meets or exceeds PWS specifications at the best overall value to the MTF and its stakeholders.

C. CHILD CARE

1. Outputs and Costs Are Identifiable

As with food and custodial service, child care has a tangible output. This is the number, or ratio, of children per child care worker. How does this output get measured? One solution is to identify inputs necessary to provide the meals, naps, play activities, snacks, bathroom facilities, and so on that meet the needs of any one child in the child care center on a typical day. The next step is to trace the steps required to perform each of these outputs and to calculate the cost of inputs used to provide each of these outputs.

Another solution is to measure the cost of outcomes, such as parent satisfaction. This can be achieved by conducting a survey to measure parent satisfaction, obtain an overview of the demand for services, and identify parent preferences for services relative to the services currently provided at the child care center. This information will help the MTF Commander to determine the inputs the MTF will use to measure costs. The next step is to trace the inputs and resulting costs to perform the determined level of service. This will provide a baseline against which contractor costs will be measured.

As previously mentioned, when calculating the cost to provide the service in-house, be sure to account for the change in costs that may occur as a result of changes in volume of service delivery. In child care, variable costs may change as a result of a change in the ratio of children per child care worker. For example, when the number of children per child care worker is four children for every one child care worker, the cost per child per hour may be \$8 per hour. On the other hand, if the ratio of children per child care worker changes to six children for every one child care worker, the cost per child per hour may change to \$6. The cost reduction occurs when variable costs decrease as a result of efficiencies gained from larger volume operations. Ignoring the changes in variable costs that result from changes in volume will result in overestimated in-house costs. This will cause in-house costs to compare unfavorably with contractor cost estimates. If the service is contracted out, the projected cost savings will be lower than the actual cost savings.

When providing child care, the potential exists for increased demand for the service. This must also be accounted for. As an example, consider the cost to provide child care for 50 children per day can be provided at \$8 per child per hour. Next, consider the potential for demand for child care to increase to 75 children per day. Costs associated for this change in demand must be accounted for. For illustrative purposes, assume this increased demand causes total child care costs (i.e., fixed and variable costs) to increase to \$10 per child per hour rather than down to \$6 per child per hour as in the previous example. In this example, failure to account for increases in total

child care costs that result from demand increases will cause in-house cost estimates to be more favorable than contractor estimates. If the service is contracted out, actual savings will be lower than projected.

Costs that change as the result of the decision to outsource, such as labor costs to perform the service, are then calculated. When these costs are identified, measured, and summed, the total is compared to the sum of the three contractor costs, as described above, to perform the service. Finally, the decision to perform the service in-house or by contract should then be based on the method that can provide the service at lower cost. Next, performance and quality are considered to evaluate the make-or-buy decision.

2. Performance and Quality Are Measurable

Identifying performance measurements for child care is more difficult than it is for food or custodial services. For example, a child may not complain that he or she did not receive milk with lunch that day. However, if the PWS states that milk is to be provided with each lunch, elimination of this task results in reduced performance and should be corrected. One way to measure performance is to periodically inspect the child care center at various times of the day to ensure all performance specifications are being met.

Another solution is to conduct a survey of parents to determine customer satisfaction, identify consumer preferences and complaints, and obtain an overview of parent demand for services. This information can then be used to by the MTF Commander to determine the acceptable performance level the MTF will use to measure contractor quality. The

inputs and resulting costs should then be calculated. This is the information that is used to develop the performance measurements for the contractor to meet or exceed.

Finally, quality of child care should be measured. The options suggested for measuring food service quality can also be applied to child care.

When costs, quality, performance, and other criteria and variables have been considered, the decision to make or buy the service can be made. The make-or-buy decision should be based on the alternative that meets or exceeds the PWS specifications at the best overall value to the MTF and its stakeholders.

D. LESSONS LEARNED

Successful outsourcing requires a well-developed plan initiated from the top down to provide the vision, incentives, and tools to support the goal. Proper planning beforehand can reap rewards later so that problems in conversion to contract and contract performance are minimized. Lessons learned by both the public and private sectors suggest the following factors or variables should be considered: outsourcing opportunities, cost of providing the service, quality level of the service provided, impact on the organizational culture, the transition plan, measurability of the results, and selection and management of the contractor.

1. Identify Outsourcing Opportunities

a. Top Management Involvement

In the private sector, successful outsourcing initiatives are the result of a top down decision making process. This requires the

active involvement of the Chief Executive Officer, Chief Financial Officer, or other executive to drive the commitment to outsource and support efforts to implement it. Top management is also actively involved throughout the development of the Request For Proposal (RFP), selection of the contractor, and implementation of the transition plan. MTF Commanders who follow this lead are more likely to have positive outsourcing experiences because their support of the outsourcing initiative will encourage those who implement it to succeed.

b. Define Core Competencies

What is the MTF mission? Which activities support the mission? Top management should clearly define the MTF mission, distinguish between activities that directly impact the mission and those that support mission accomplishment, and identify areas for improvement. A Needs Assessment Report can be prepared to identify opportunities for improvement. This report addresses current practices, the impact of these practices on the MTF, and the potential for managing the activity more effectively. The idea is to develop a clear picture of in-house competencies, a common understanding of services critical to the MTF mission, and comprehension of the need for improvement. Once this has been accomplished, top management can discern which activities to consider for outsourcing.

c. Determine Objectives

Prior to starting an outsourcing initiative, the MTF Commander should determine the objectives for the service to be outsourced. The primary objective may be performance of the service at minimum cost, increased efficiency and effectiveness, improved

readiness, employment for the local community, fulfillment of patient needs and desires for the service, retention of control over the service, or some other objective. MTF Commanders should then clearly state the objective for outsourcing and expectations from the contractor. Later, the MTF Commander should evaluate whether outsourcing achieved this objective and retain lessons learned from this evaluation for incorporation into future outsourcing initiatives.

d. View Benefits from a Life Cycle Approach

The full benefits of outsourcing may not be realized immediately after outsourcing the activity. Outsourcing produces the most favorable results when the contractor is allowed to reengineer the activity through introduction of new technologies and best business practices. This reengineering process always requires time for the contractor to analyze the existing process and develop more efficient business practices. In addition, disagreements over the scope of work or contractor methods are common during the initial stages of the contract. Fortunately, these differences can usually be satisfactorily resolved over time. For these reasons, the contractor should be evaluated throughout the contract period and from a life cycle perspective.

e. Assess the Advantages and Disadvantages of Outsourcing

An assessment of the advantages and disadvantages should be included as part of the outsourcing planning process. This provides MTF Commanders the opportunity to develop an understanding of how outsourcing may improve service delivery or make it worse. Ability to identify advantages and disadvantages ensures that potential

disadvantages are addressed during contract negotiation. In any case, a careful assessment will reduce surprises after contract award.

f. Start with the Best Candidates for Outsourcing

The MTF Commander should strive for early successes in outsourcing and use these successes to increase confidence throughout the MTF that expanded outsourcing reduces costs and increases efficiency. Conversely, the MTF Commander should avoid early failures that could discourage expanded outsourcing. Other things equal, the more uncertainty involved in the activity, the more likely it should be retained in-house. If in-house personnel have trouble defining the scope of the work, then it will be difficult to describe it to the contractor. These considerations suggest that an MTF Commander should start where outsourcing promises success. Later, when more outsourcing experience is gained, activities with increasingly more complex measures of cost, quality, and performance can be contracted out.

2. Analyze the Cost of Providing the Service

Measuring the costs of in-house and contract service delivery is difficult. This is partly due to insufficient governmental accounting systems and partly due to the failure to apply a consistent methodology that ensures all relevant costs are included in the make-or-buy analysis. Therefore, it is often necessary to manually calculate various costs relevant to the outsourcing decision.

A cost comparison usually involves bidding by contractors and in-house personnel. This requires the cost comparisons between in-house and contract performance and resulting bids to be based on identical PWS documentation. Ideally, this results in what is commonly termed as

"leveling the playing field" or "comparing apples to apples, not apples to oranges." The objective of the cost comparison is to permit accurate comparisons of in-house and contractor costs through a competitive bidding process. Therefore, the PWS should provide a detailed description of the required quality and quantity of work, level of service, and time and other restrictions on the work. It must be comprehensive to ensure that either in-house or contractor performance will meet all requirements at minimum cost.

All costs relevant for both in-house and contractor performance should be included in the cost comparison. The fixed costs of the MTF that are the same with either in-house or contract performance are not included in the cost comparison. Likewise, sunk costs should be ignored. Another cost that should not be included is the cost to prepare the cost comparison. DoD agencies are often surprised that evaluating the cost of performing a service costs money. They are dismayed to discover that these costs cannot be reimbursed. OMB Circular A-76 states that costs associated with conducting cost comparisons are not to be included in the in-house or contractor cost estimates. This is considered an administrative expense associated with good business practices and is not relevant to performance costs.

Costs associated with preparing the cost comparison include the cost to gather the information necessary to: quantify the inputs required to produce service delivery outputs, measure performance, evaluate quality, assess efficiency, calculate savings, estimate contract administration costs, and compute one-time conversion costs.

MTF Commanders may be tempted to pay for additional data in attempt to obtain perfect information for use in forming the make-or-buy decision.

For most cost comparisons, the major cost in conducting a cost comparison will be in time, not money. Preparation of make-or-buy analyses requires time, not necessarily additional personnel. MTF Commanders should approach the comptroller, progress reports and statistics, efficiency review, total quality leadership, performance improvement, quality assurance, health care planning, and patient administration departments to prepare much of the data used to form the make-or-buy decision.

The need for additional data will be determinant upon the complexity and scale of the service being considered for outsourcing. Before obtaining the additional data, the potential benefits must be compared to the costs of acquiring the information. If costs to obtain the data deemed necessary to form the make-or-buy decision outweigh the benefits, then the additional information should not be obtained. Furthermore, if the additional information costs are high relative to the potential benefits to be gained from the data, this may serve as an indicator that the service should not be contracted out. In this case, other alternatives, such as stopping service delivery altogether or not getting into delivery of the service at all, should be pursued.

Throughout the cost comparison process, it should be ensured that MTF and contractor cost comparisons include costs over more than one performance period. OMB Circular A-76 and successful outsourcing firms recommend that cost comparisons span a period of three to five years. A performance period generally covers one fiscal year. One reason is that

potential cost savings from outsourcing may not be realized in the initial performance year. This may occur because of significant contractor start-up costs or large one-time conversion costs. These costs should be spread, or amortized, over multiple performance periods. Another reason is that short-term cost comparisons for one year may not account for relevant inflation costs of labor and materials used to provide the service.

When all cost comparison information is gathered, the lowest overall cost for performance of the service may be determined by comparing the costs of in-house performance to the sum of the contractor costs, contract administration costs, and conversion costs. The OMB Circular A-76 Supplement provides contract administration cost estimates to be used for cost comparisons. These cost estimates are based on the MEO staffing level.

One-time conversion costs include personnel related costs, material related costs, and other costs. Personnel related costs include unemployment compensation, accrued annual and sick leave benefits, and other severance costs paid to displaced personnel. Material related costs include costs associated with the preparation and transfer of government property or equipment to be made available to a contractor for use in providing the service. Other costs include any other one-time conversion costs, such as penalty fees from terminating rental or lease agreements, costs of unused or partially utilized facilities and equipment until other uses are found or they are sold, and other costs associated with the transaction.

Two easy to overlook costs that should be considered are production losses and inefficiencies costs. These costs may result during the transition to contract performance. Although most outsourcing initiatives will not result in significant inefficiencies, if substantial inefficiencies and production losses are anticipated, the resulting costs should be included in the cost comparison. These inefficiencies can be highly variable and difficult to quantify. The costs can be calculated by estimating the number of lost man hours for MTF personnel due to inefficiencies and production losses during conversion to contractor performance.

When all the contractor cost estimates and contract related costs have been collected and compared to in-house cost estimates, the make-or-buy decision can be made. The MTF Commander should select the alternative that meets or exceeds the PWS specifications at the best overall value to the MTF and its stakeholders.

While considering outsourcing as an alternative to the current method of providing a service, other alternatives should be evaluated as well. Although the lease and ISSA alternatives both require completion of cost comparisons, other alternatives, such as the addition of TAD personnel, do not. Nevertheless, the cost of all or several viable alternatives should be compared to the current method of service delivery. These comparisons enable the MTF Commander to make an informed make-or-buy decision.

Cost comparisons are useful in determining the competitiveness of in-house and commercial market prices to provide the service. In addition, cost comparisons may be useful when comparing the efficiency

of service delivery before and after outsourcing. For example, if in-house performance of food service costs \$5 per meal served, compared to the contractor cost of \$3.50 per meal served, these figures may be used to reflect the relative efficiency of in-house and contractor service delivery. A cost comparison, however, does not reflect the potential cost savings from outsourcing. It is merely a tool managers use in forming the decision to make or buy. The potential savings is not the difference between the in-house cost and the contracting cost. It is the sum of avoidable and incremental costs, as noted in Chapter III.

While conducting comprehensive cost comparisons is important to forming the decision to outsource, estimating cost savings is equally significant. Estimation of cost savings provides information on the costs avoided in the long term. As with cost comparisons, savings estimations serve as another measure of relative efficiency attained by shifting service delivery from or to in-house or contract performance.

Most cost savings tend to come from competition rather than outsourcing. Competition provides MTF Commanders with alternative sources of service delivery, thereby enabling MTF Commanders to control costs and quality. Other savings come from having fewer personnel perform the work, not necessarily from lower wages and salaries.

It is necessary to be aware that discrepancies in projected and actual cost savings from outsourcing initiatives may occur if certain relevant costs are not considered or if irrelevant costs are included in savings estimates. In addition, analysis of costs savings before and after outsourcing may differ because projected cost savings are overestimated or certain costs are underestimated or omitted.

Projected cost savings from outsourcing initiatives may be overestimated if sunk costs (i.e., food service wages paid in the past) are included in the estimated cost of performing the service. Sunk costs should never be included in cost comparisons or savings estimates. Including these costs results in larger projected cost savings than are actually realized.²⁷

Costs to heat empty building spaces or for maintenance of idle or under utilized equipment may be omitted from the cost savings estimate if these costs are assumed to go away as a result of the outsourcing decision. In practice, these costs often continue because even unoccupied space and idle equipment require a minimal level of maintenance until the building spaces and equipment are occupied or used for other purposes. Omitting these costs can cause projected savings to be higher than actual savings.

Omission or underestimation of retirement, unemployment compensation, and health care benefit costs from the cost savings estimates can cause large discrepancies in projected and actual savings. These discrepancies occur when the assumption is made that outsourcing the service will cause all in-house personnel related costs to go away. This is not the case. These costs can be significant and should be included in the contract conversion cost of outsourcing an activity.

²⁷Verma, Kiran, "Covert Costs of Privatization: Lessons from the Closure of Three Public Chronic Care Hospitals in Massachusetts," *Public Budgeting and Finance*, 13(3) Fall 1996: 53-55.

Since personnel costs often compose the largest portion of service delivery costs, omitting them may lead to substantially overestimated projected cost savings.

While outsourcing, the MTF should maintain accountability of all cost estimates and projected cost savings. Later, after outsourcing has been initiated, projected cost savings and supporting documentation should be reviewed to provide a comparison of projected versus actual cost savings. This process can provide valuable feedback on costs to consider and ignore during future outsourcing initiatives.

An outsourcing plan should include the implementation steps necessary to realize cost savings and a time frame for these expected savings to be realized. In addition, the outsourcing plan should include the costs to implement these steps.

3. Evaluate the Quality Level of the Service Provided

Successful outsourcing requires contract specifications that define and measure the quantity and quality of the service and determine the conditions for service delivery. This requires the MTF to be able to measure outputs, both quantitatively and qualitatively, and at a reasonable cost. Measuring these outputs is easier when services have physical outputs, such as number of meals served and pounds of laundry washed, as opposed to less physical outputs, such as health and child care. Regardless of the complexity associated with measuring outputs, a step-by-step review of specific processes used to produce the outputs can help establish benchmarks and define expectations for improvement from potential contractors.

4. Consider the Impact on the Organizational Culture

It is necessary to identify and formally plan the organizational changes required to implement and maintain outsourcing initiatives. Contracting out requires significant changes in many MTF processes. Some of these changes are cultural. These changes will be slow to implement. For cultural changes to succeed, MTF Commanders need to develop an outsourcing transition plan to merge in-house personnel and processes to contractor personnel and processes and manage the transition plan over the period of time it will take to achieve these changes.

5. Measure the Results

Attempts to develop quantitative and qualitative measures for measuring contractor service delivery can be time consuming. However, the process is more likely to be successful when it includes: involvement of functional expert and Contracting Officer; development of performance criteria; establishment of penalties for substandard work; an assessment of contract scope; determination of contract the performance period, consideration of contract scale, and; identification of the number of activities to be outsourced together, or as a bundle.

a. Have Functional Participation

Involve experts from the function being considered for outsourcing to gain their input into the processes involved in performing the service. Functional experts should be involved throughout the outsourcing initiative by having input into the PWS, RFP, and contract preparation. This ensures that all processes and contractor responsibilities are outlined in the contract, enhances

ability to clearly define performance measures, and may limit disagreements between MTF and contractor personnel regarding the scope and performance of work.

b. Involve Contracting Early in the Process

The Contracting Officer should be involved throughout the outsourcing initiative to provide input regarding the types of contracts that will best meet the needs of the MTF. Active involvement is also necessary for preparation of performance based PWS and RFP to ensure full advantage of the contracting tools available to the MTF are used to protect the interests of both the MTF and the contractor and to make the outsourcing initiative a success.

c. Develop and Use Performance Criteria

The MTF has the right, and the responsibility to all stakeholders, to expect a satisfactory level of performance from the contractor. Tax payers and elected officials expect DoD agencies to be effective managers of tax dollars. Therefore, MTFs have the responsibility to prepare service delivery contracts that balance efficiency and accountability. This includes developing the methodology for performance measurement, such as surveys, step-by-step analysis, and inspections, as well as the structure of the data base to store this data. Finally, this requires instructions to be written on how to collect and record performance data. This enables measurement of performance over time and provides a source of reference if disagreements over performance arise.

Despite the difficulty often associated with identifying performance measures for certain activities, careful planning is

necessary to ensure a well written performance based PWS and RFP that contains output oriented measures of performance. These measures should be both quantitatively and qualitatively measurable to provide the contractor with a baseline of performance to follow and improve upon throughout the contract performance period. In the DoD, the PWS and RFP have traditionally been used to describe how the contractor should perform the service rather than focus on what the contractor should do in the performance of the service and have failed to provide a basis for evaluating contractor performance.

An MTF can benefit most from outsourcing when the contractor has the flexibility to apply new technologies and best business practices to reengineer the support activity. The PWS and RFP should encourage bidders to adopt new ways of doing business to reduce costs and improve service delivery, and not provide obsolete technology or business practices. In fact, successful private outsourcing firms often use performance incentives that reward contractors for reducing costs and/or improving service quality and responsiveness. Accordingly, PWS and RFP documentation should contain performance standards that clearly identify what the contractor should do and the expected outputs or outcomes, not detailed specifications on how the contractor should perform the work. The PWS and RFP should also include incentives for improved performance. This is best achieved by involving both functional experts and contract personnel in the development of the PWS and RFP.

The PWS may include a statement that cost savings achieved by the contractor will be shared wherein the MTF and contractor split

the savings. DoD cost savings are commonly split 80-20. The MTF, or government, receives 80 percent of the cost savings while the contractor receives 20 percent of the cost savings. Likewise, if performance and/or quality improves by some pre-determined measurable amount within a specified time frame, the PWS may state that the contractor receives a bonus. Of course, this also means that the MTF and contractor also share the risk of incurring additional costs, delivering lower quality, or providing reduced performance. To reduce the risk of experiencing these dilemmas, penalties should be developed.

d. Establish Penalties for Substandard Work

Problems with the PWS or contract can create conflict between the MTF and contractor. This may result when PWS documentation is prepared for bid before completing an analysis of private sector capabilities. Therefore, early research of the services available from the private sector is important. Once the MTF Commander, Contracting Officer, and functional expert know what to expect from contractors, the contract can be written to ensure the contractor can be penalized or that the contract can be terminated if the contractor fails to achieve certain objectives and service levels. For example, the MTF can include penalties in the PWS wherein the contractor pays a penalty or is paid less for failure to achieve a pre-determined level of cost, quality, and/or performance by a certain deadline.

e. Contract Scope

The primary source of problems in outsourcing is disagreement between the outsourcing agency and the contractor over the scope of the PWS. To avoid misunderstandings, the MTF and contractor

should discuss the PWS and mutually agree upon the key contract provisions. The contractor should also have the opportunity to comment upon and influence the final PWS, as contractors may have more experience in developing successful outsourcing contracts in their area of specialization. Since outsourcing contracts can be extremely complicated, a well trained staff of contracting personnel is essential to successful outsourcing.

f. Long-Term Contracts

An MTF can benefit from outsourcing over the long-term, primarily through the contractor's reengineering of business processes. Accordingly, one or two year contracts limit contractor opportunity to apply new technologies or best business practices. As a result, private sector firms prefer to use service contracts that extend three to five years or longer.

The MTF can write contracts with performance periods of up to five years as well by incorporating option periods into the agreement. Option periods in multiple year contracts permit the MTF to either continue with the contractor or to end the contract at the end of each performance, or option period, usually at the end of each fiscal year. Ability to end the contract at the end of each option period, or fiscal year, prevents the MTF from being locked into an unsatisfactory outsourcing arrangement for the long-term if the arrangement does not work out. If the option will not be exercised, however, the MTF needs to notify the contractor so plans can be set in motion to end performance at the end of the option period. Meanwhile, the MTF needs

this lead time before the contract ends to arrange for other means of providing the service to prevent disruptions in service delivery.

Should the MTF desire to get out of the contract before the end of the option period, the contract can be terminated at any time, provided there is a valid reason, such as contractor non-performance. However, with contract termination, the MTF may be required to pay penalties to the contractor. Likewise, penalties may be paid to the contractor if the MTF cancels the contract. In both cases, the contractor can appeal the termination or cancellation and seek redress for contract non-renewal. In contrast to contract termination or cancellation, the MTF has the unilateral right to exercise or not to exercise the option to extend the contract to the next option period. Failure to exercise the option ends the contract because each option period, or fiscal year, equals one performance period. No penalties are paid and no appeals can be made because the performance period for that option period has been completed. In essence, the each option period is a miniature contract within the five year contract.

Long-term contracts that include option periods are best for activities that have known outputs, identifiable quality measurements, relatively stable costs, and measurable performance levels. The more risk associated with measuring these variables, the more a short-term initial contract of one to two years may be preferred. This also prevents the MTF from being locked into an unsatisfactory outsourcing arrangement. If contractor performance is satisfactory during the initial one or two year contract, the MTF may enter into a long-term contract.

g. Large Scale Contracts

The recent regionalization of MTFs is conducive to large scale outsourcing. For example, food service and other support activities can be readily contracted out for all hospitals in the region. When outsourced under one outsourcing agreement, contract administration and monitoring cost savings may be realized. When centrally managed, MTF Commanders can achieve a high degree of service quality at lower cost.

h. Outsource Multiple Activities

The private sector tends to outsource multiple activities rather than single services.²⁸ As with large scale contracts, this approach streamlines contract management and oversight efforts, promotes coordination between outsourced functions, and affords top management increased control and responsibility over outsourced activities. Outsourcing single activities is not the optimal approach to outsourcing as it results in higher oversight costs, reduced leadership control, and poor coordination among support functions. However, it may be the only option in some cases.

6. Contractor

As with cost comparisons, information is needed to select responsive contractors and to administer and monitor the contract. The depth of the information desired will vary based on the complexity of the service being outsourced, the type of contract being used, the uncertainty associated with outsourced service delivery, and the

²⁸Office of the Under Secretary of Defense (Acquisition and Technology)
22A.

differences in risk adversity of the MTF and potential contractors. The more complex the activity being outsourced, the more likely additional information will be desired to ensure success. Likewise, when risk is unequally shared in the contract, more information may be desired to limit the risk. When uncertainty associated with the service to be outsourced is high, additional information will be sought to reduce the uncertainty.

In practice, the MTF will never have perfect information about potential contractors. As a result, the MTF Commander may seek assurance that potential contractors will share the same goals and objectives and that contractual obligations will be met. Costs will be incurred to obtain additional information about them. Before seeking additional data, the projected benefits to be derived from this information should be weighed against the cost. If the cost outweighs the potential benefit, then the additional information should not be acquired. Likewise, if the cost to obtain additional information to administer or monitor the contract outweigh the potential benefits, then the additional information should not be sought. When sufficient information has been gathered about potential contractors, the selection process can begin.

Private sector firms that advocate outsourcing as a result of positive experiences cite a successful, well-managed relationship between the firm and the contractor as the common success factor.²⁹ This relationship begins during the contractor selection process. To

²⁹Kralovetz, Robert G., "A Guide to Successful Outsourcing," *Management Accounting* October 1996: 34.

begin this process, it is necessary to select potential contractors and review their business approaches. Next, an outline of characteristics deemed essential to an outsourcing relationship and that addresses the complexity level of the activity being outsourced is needed. The MTF Commander, Contracting Officer, and functional expert must also consider all factors, from service delivery processes through managing the conversion to contract. After this, potential contractors should be solicited to come up with proposals. The next step is to open negotiations by outlining MTF needs to potential contractors. This includes providing data on projections for the next five years to compare recurring costs with the projected costs of the contractor. When this review is completed, the MTF should select the contractor that meets the criteria of flexibility, efficiency, professionalism, and team orientation.

Contractors that meet these criteria will have the outsourced activity as the core business, be committed to the business of outsourcing, emphasize team work and independence in the outsourcing relationship, demonstrate a knowledge of the health care business and the capacity to expand this knowledge on a real-time basis, and dedicate human relations specialists who can limit morale problems by creating a positive work environment for both MTF and contractor personnel.

Fortunately, DoD contracting processes have changed since the implementation of Federal Acquisition Streamlining Act (FASA) of 1994, Federal Acquisition Reform (FAR) Act of 1996, DoD Directive 5000.1, and DoD Regulation 5000.2. These changes enable MTFs that foresee problems

with an unreliable contractor to select a more responsive one. MTFs no longer have to select unreliable contractors using sealed bid procedures that require selection of the lowest bid.³⁰

7. Develop a Transition Plan

A transition plan addresses the seamless transfer of service delivery from in-house to contract, introduces change, and helps in-house and contract personnel manage the change effectively. Affected personnel and unions should be involved early in the process. The MTF personnel should meet with the contractor to identify potential problems, agree how problems will be resolved, and work with the contractor to resolve problems that arise after contract award. The transition plan should also specify processes for meeting MTF expectations and target areas for improvement. Successful transition plans should result in continuously improving service delivery that is visibly linked to MTF outsourcing objective.

a. Manage Contractor Personnel

If the outsourced service delivery will be performed at the MTF, the contractor must provide an on-site supervisor to manage personnel issues. If the activity will be performed elsewhere, the contractor should assign a point of contact to the MTF to manage issues and enhance communication.

b. Communicate with In-House Personnel

Communication is key to the successful transition of affected personnel facing relocation or transition to contractor

³⁰Tighe 9.

delivery of the service. In fact, OMB Circular A-76 requires affected personnel and unions to be informed of outsourcing plans.

Personnel issues are a primary concern for everyone involved in outsourcing initiatives. In the private sector, these issues pose a constraint to the expansion of outsourcing. Although outsourcing is likely to remain a sensitive issue with in-house personnel who are relocated as a result of the contracting initiative, successful outsourcing firms address personnel concerns, plan for personnel relocations, and limit the impact of outsourcing decisions on affected workers. This is accomplished by effective communication throughout the outsourcing process.

Effective communication includes keeping personnel and unions informed about outsourcing initiatives under consideration, the rationale for outsourcing, and the transition and relocation assistance plans for affected personnel. Finally, successful outsourcing includes offering personnel and unions the opportunity to provide input into the transition plan. In the private sector, labor unions are concerned about outsourcing initiatives. In fact, outsourcing has become a central issue in union negotiations.³¹

Relocation assistance plans should offer personnel the opportunity to seek employment elsewhere in the MTF organization. For personnel who cannot be relocated within the command, then placement services should be offered and severance pay based on length of service should be paid. Some personnel will qualify for and accept retirement

³¹Office of the Under Secretary of Defense (Acquisition and Technology) 24A.

while others will be candidates for retraining. In the business environment of today, the social contract between private firms and employees has shifted from a commitment to a lifetime of employment security to one of employment opportunity only.

When outsourcing a large activity, the contractor must often hire additional personnel within a short period of time after contract award. The only practical solution for the contractor may be to hire personnel displaced by the outsourcing initiative. OMB Circular A-76 requires that commercial activities contracts include "right of first refusal" to affected personnel as a condition of the service contract. Nevertheless, some personnel will not be hired since contractors can often perform the service with fewer personnel than were used in-house. In addition, personnel that relocate to the contractor organization may do so with a reduction in pay and benefits since contractor wages and salaries are based on local market and economy conditions.

Private sector leaders estimate that about two thirds of affected personnel are hired by the contractor. One third respond well to the new arrangement. These personnel take advantage of new career opportunities available to them and move up quickly in the contractor organization. Another third of affected personnel have difficulty adjusting to the contractor work environment and eventually leave to accept employment elsewhere. The other third of displaced personnel are relocated into another part of the in-house organization, leave through attrition, or immediately seek employment elsewhere.³²

³²Office of the Under Secretary of Defense (Acquisition and Technology)
24A.

8. Manage the Contractor Relationship

Outsourcing is appropriate as long as the boundaries between the MTF and contractor are very clearly defined. Therefore, it is important for the MTF and contractor to openly discuss and agree on measures of performance, the scope of work, transition and personnel relocation plans, contract and personnel management resolution plans, and termination clauses before agreeing on a price and signing the contract. A well-written contract prevents price gouging and promotes trust between the MTF and the contractor. In effect, the contract should protect the interests of both sides.

a. Anticipate Contract Management Problems

Each outsourcing contract should clearly state terms for pricing, scheduling, confidentiality, modifications, and termination. In addition, emergency back-up services should be specified in case of disasters that could potentially result in loss of service.

b. Educate and Train Contract Oversight Team

Successful outsourcing firms tend to perform contract management and oversight with a small group of functional experts and contract administrators who communicate with contractor personnel on a daily basis. This oversight team usually is co-located with the contractor at the in-house or contractor work site. In fact, the potential savings and flexibility of outsourcing can be lost if the MTF imposes a distant governmental control structure on the contractor.

c. Partnerships

A key factor in successful outsourcing is building a partnership between the MTF and the contractor. While the oversight

team must hold the contractor to high standards, the MTF should establish a team oriented rather than adversarial relationship that emphasizes shared goals and objectives. The partnership should also work to identify and resolve potential problems before they impact service delivery.

d. Take Advantage of Market Dynamics

Outsourcing benefits accrue by applying the competitive nature of the marketplace to support functions previously performed in-house. This can be achieved by reviewing industry price lists, attending industry and government trade shows, and obtaining prices from other contractors. A competitive environment may also be achieved through periodic competition of the outsourced service, by maintaining more than one supplier for a support activity, and by using performance incentives that encourage cost reductions and service improvements.

In this chapter, the variables encountered in make-or-buy decision making have been analyzed. In addition, outsourcing lessons learned from both the public and private sector have been described. In the next chapter, conclusions and recommendations will be drawn from the data gathered to suggest under what circumstance BUMED hospitals should make or buy services.

V. WHEN SHOULD BUMED HOSPITALS MAKE OR BUY SERVICES?

A. INTRODUCTION

This research was designed to provide MTF Commanding Officers and Executive Officers within the BUMED health care community with the necessary management tools to facilitate the make-or-buy decision process at the MTF level. Making this decision is a complex process that requires consideration of a range of issues, as follows.

Chapter I provided an overview of the rapid changes in the global, national, and DoD environments that have led to expanded use of make-or-buy analysis by MTF Commanders and other DoD officials. Make-or-buy analysis was described as a tool decision makers can use to make informed resource allocation decisions.

Chapter II opened with a discussion of the issues related to make-or-buy analysis. These issues include the DoD changing roles and missions, the public and private health care crisis, the OMB commercial activities program, and stakeholder interests. Next, terms related to contracting out commercial activities were defined. These definitions were followed by a description of problems revolving around the issue of which activities should be outsourced.

A list of criteria that may be used to evaluate the make-or-buy decision were included in Chapter II. Criteria discussed include: the mission, readiness, the best interest of the patients, FTE limits, costs, quality, volume of service, top management support and involvement, MTF culture, stakeholder interests, personnel relocation issues, contractor performance measures, contractor selection and management, and the contract. Following this, the focus turned to

variables that should be used to form the make-or-buy decision. These include costs, quality, and advice from outside experts.

The next section of Chapter II explained why MTFs might outsource. This included a discussion of the theory of outsourcing which revolves around issues of economy, efficiency, effectiveness, modernization, readiness, infrastructure reduction, and change of mind. Reasons for outsourcing include federal and DoD policies that require contracting out of commercial activities and a list of common reasons.

Following this, the next section of Chapter II discussed why make-or-buy analysis is important to making informed decisions. Thereafter, the advantages and disadvantages of outsourcing were listed. The final portion of Chapter II described alternatives to outsourcing.

Chapter III provided background information on Naval Medical Center San Diego. Following this, background information of the medical center's food, custodial, and child care service outsourcing initiatives were specified. Next, the criteria used by the medical center to evaluate the make-or-buy decision were described. This was followed by discussion of the variables that the medical center used to form the make-or-buy decision. After this, quantitative and qualitative costs relevant to the make-or-buy decision were spelled out.

Advantages and disadvantages of outsourcing, noted by medical center staff, were then identified. This was followed by the lessons that the medical center staff learned from the food service outsourcing initiative. The last section of Chapter III introduced contractor background information, followed by a description of the qualitative and quantitative costs of the three outsourcing initiatives.

Chapter IV outlined the characteristics of the make-or-buy analyses conducted by Naval Medical Center San Diego. This included application of the make-or-buy process to other MTFs. The final section of Chapter IV provided outsourcing lessons learned in both the public and private sectors.

B. CONCLUSIONS

The MTF Commander or ESC often has ultimate responsibility to make the decision whether to make or buy a service. Therefore, the MTF Commander should develop an outsourcing plan that will increase the potential for the outsourcing initiative to be successful.

1. Develop and Use an Outsourcing Plan

An outsourcing plan includes providing the vision, incentives, and tools to motivate those who implement it to succeed. In addition, both the contracting officer, comptroller, and functional expert should be involved throughout the outsourcing initiative to provide input into issues unique to the service being considered for outsourcing. The outsourcing plan should include a personnel relocation plan, a transition plan, a feedback plan, and a make-or-buy analysis.

a. Personnel Relocation Plan

A personnel relocation plan should be developed to transfer affected in-house personnel from current duties to positions elsewhere in the organization, to employment with the contractor, or to work for another organization. Some personnel will retire early or leave the MTF when their spouses implement a PCS move. Therefore, attrition of in-house personnel should be included in the relocation plan. This plan

should ensure notification of in-house affected personnel and unions occurs early in the outsourcing initiative.

Notification should include information about the outsourcing initiative under consideration, the reason for outsourcing, and the transition and relocation plans for affected personnel. Affected personnel and unions should be permitted to provide input in the transition plan. In addition, the MTF should effectively communicate with personnel and unions throughout the outsourcing initiative and address concerns. Outsourcing is only possible when personnel and union contractual/legal requirements have been met.

b. Transition Plan

The outsourcing plan also should include a transition plan to promote the seamless transfer from in-house to contract service delivery. This introduces personnel to the change in service delivery and helps in-house and contract personnel manage the change effectively. In addition, the transition plan outlines the procedures the MTF and contractor agree upon for resolving existing and potential problems.

c. Feedback Plan

The feedback plan describes actions necessary to determine whether outsourcing achieved the cost savings projected and whether these cost savings are realized within the time frame expected. In addition, the feedback plan should enable the MTF Commander to determine whether the objective to be achieved from outsourcing is achieved. If projected and actual savings differ significantly and/or the objective has not been achieved, early detection will help identify the source of the deviation and increase the opportunity for full resolution of the

problem. Finally, lessons learned from the outsourcing initiative should be recorded for incorporation into future outsourcing plans.

d. *Make-or-Buy Analysis*

The outsourcing plan should outline the information to be collected and evaluated to form the decision to make or buy a service. Make-or-buy analysis is a complex process that requires consideration of a range of qualitative and quantitative criteria and variables.

Determining which of these are relevant to a given make-or-buy decision is also a complex process. In addition, many of these criteria and variables require subjective judgement by the MTF Commander as well as input from several departments. These departments include, but are not limited to, the progress reports and statistics, comptroller, efficiency review, total quality leadership, performance improvement, quality assurance, health care planning, and patient administration departments.

To begin the make-or-buy analysis process, the MTF Commander needs to define the MTF mission and to identify the core competencies. The MTF Commander should identify which activities the MTF is best at performing and retain these activities in-house. With a clearly defined mission, the MTF Commander can better determine which activities must be retained in-house and which are support services that can be outsourced. Next, the support activities should be ranked in order of their potential for successful outsourcing. Activities that have clear measures of cost, quality, and performance will be easier to contract out than services that have vague or more complex measures of cost, quality, and performance.

The next step is to set the objective to be achieved from outsourcing. This objective may be to reduce costs, improve quality, satisfy patients, comply with CNO orders or some other objective. The activity to consider for outsourcing must also be identified. These two considerations will drive the identification of the criteria and variables relevant to the make-or-buy decision. In addition, this determines which departments the decision making information will come from. Listing reasons why this activity shows promise for outsourcing as well as the advantages and disadvantages should be included in this step. These factors will help direct attention to issues, such as regulations, that need to be addressed during the outsourcing initiative.

After setting the objective, the scope of the outsourcing initiative should be determined. Will the activity be outsourced as a single function or combined with other services to be contracted out as multiple functions? Will the activity be outsourced for the short-term or for the long-term? Will this service be contracted out only for this MTF or will it be outsourced for some or all of the MTFs in the region? The answers to these questions provide insight into the scope of work and type of contract that will be developed to attract potential contractors and manage service delivery. In addition, these factors will determine whether a simplified or full cost comparison will be conducted. Finally, responses to these questions help determine the qualitative and quantitative criteria and variables relevant to the make-or-buy decision.

The qualitative and quantitative criteria and variables to evaluate the make-or-buy decision must be identified early in the outsourcing initiative. This is the next step in the make-or-buy analysis. Some criteria and variables will be mandatory to consider, as with outsourcing commercially available activities.

The OMB Circular A-76 requires an activity to meet certain criteria before contractor performance of the service will be approved. Specifically, the activity must: 1) meet Secretary of Defense approval when related to national defense or intelligence security; 2) not be an inherently governmental function; 3) have satisfactory commercial sources available; 4) meet or exceed generally recognized industry performance standards; 5) be fair and reasonably priced; 6) have cost estimates consistent with the President's Budget; 7) meet the minimum cost differential (i.e, savings) of ten percent of in-house personnel costs or \$10 million over the performance period; and 8) not establish an employer-employee relationship between the government and contractor employees.

While current federal and DoD policy encourages outsourcing to achieve both cost effectiveness and efficiency, the focus often shifts to the cost of performing the service in-house or by contract. This often becomes the sole basis by which the make-or-buy decision is made. MTF Commanders should remain alert throughout the decision process not to fall into this narrow focus because qualitative criteria or variables can often be more important.

Although the mandatory criteria must be considered, other criteria and related variables should also be included in the make-or-

buy decision process. This requires the relevance of each criterion and variable to be established. A key question to ask is, does this add value to the decision?

It must be kept in mind that the criteria and variables relevant to forming the make-or-buy decision for one activity may be more or less relevant in forming the make-or-buy decision for another activity. For example, criteria used to evaluate the decision to outsource food service may include costs, quality of service, and support of the mission, in this order. While these same criteria may also be used to form the decision to outsource another activity, such as child care, the relevance of the criteria may shift in relative importance. These same criteria may now be evaluated for outsourcing child care in the following order: quality of service, support of the mission, and costs.

When the relevant criteria and variables have been identified, they must be weighted and listed in order of priority, as in the above example. This provides the MTF Commander an outline to guide the decision process and reduces the potential for losing sight of the relative importance assigned to the quantitative or qualitative criteria and variables to be considered.

The following section suggests additional criteria that should be used to evaluate the make-or-buy decision. In the section after this, variables that should be used to form the make-or-buy decision are suggested.

2. What Criteria Should Be Used to Evaluate the Make-or-Buy Decision?

One method to assess this question is to identify the minimum threshold requirements for each criteria that must be met before outsourcing will be approved. If potential contractors are able to meet these thresholds, then outsourcing is possible. Conversely, if the bidders cannot meet or exceed these thresholds, then outsourcing is not attractive and the service should be retained in-house.

a. The Mission

When outsourcing a support service permits in-house resources to be focused on performing activities that contribute directly to the mission, the service should be contracted out. If outsourcing will not achieve this, then the service should be performed by in-house personnel.

b. Readiness

If contracting out the support activity will enable in-house personnel to hone skills necessary to support wartime and other operational readiness requirements, the service should be contracted out. Otherwise, in-house service delivery is more attractive.

c. The Best Interest of Patients

The MTF should focus on employing the combination of in-house and contract resources to perform the services that are in the best interest of healthy patient outcomes. When outsourcing increases patient access to the service or improves patient outcomes, the service should be outsourced. If not, the service should be retained in-house.

d. FTE Civilian Employee Limits

Contractors often use fewer personnel to provide the commercial activity previously performed in-house. Additionally, in-house staff is often reduced as a result of contracting out the service. This translates into ability of the MTF to reduce or remain within FTE limits. Although OMB Circular A-76 prohibits outsourcing solely for the purpose of remaining within FTE limits, outsourcing may indirectly achieve this goal.

e. Costs

Does the make-or-buy analysis indicate that contractor performance is more cost effective than in-house performance? If so, the service should be outsourced. If not, the service should be retained in-house. Costs considered in the make-or-buy analysis are discussed subsequently as variables that should be used to form the make-or-buy decision.

f. Quality

Compare in-house performance to contractor performance of the activity to determine whether the contractor's service capabilities can meet or exceed MTF capabilities and at what cost. If the contractor can perform the service equally well or better, the service should be contracted out. Otherwise, the service should be retained in-house. Quality is discussed below to suggest variables that should be used to form the make-or-buy decision.

g. Volume of Service

Is the contractor willing and able to adjust personnel, equipment, and capital requirements to match fluctuations in the volume

of the service being performed? At what cost? The more willing, capable, and reasonable the contractor is in this area, the more flexibility the MTF will have in matching changes in service volumes.

h. MTF Culture

It is necessary to compare the MTF and contractor cultures to identify methods for overcoming barriers that may prevent successful outsourcing. This may require a change in MTF business processes, such as, task requirements, technology, systems, people, organizational structure, economic environment, political environment, mandates, visions, values, and missions. Culture takes a long time to change. However, cultural changes are necessary to gain internal acceptance of outsourcing and to achieve successes in its implementation.

i. Stakeholders

Will outsourcing support the federal government goal to reduce the budget deficit and debt? Will contractor performance of the service achieve cost savings necessary to support DoD modernization efforts? Will contracting out the service contribute to the health care system goal to contain costs? These are some questions that arise from the federal government, DoD, and health care system stakeholders. Other stakeholders include MTF personnel, MTF managers, patients, contract employees, contract managers, taxpayers, elected officials, and upper echelons in the chain of command.

The MTF Commander should identify issues significant to the MTF's key internal and external stakeholders, and how the MTF will to address those issues. Input from internal and external stakeholders should be requested during the planning phase because outsourcing

efforts will be more successful if the MTF considers who the stakeholders are and includes them in the planning process. Outsourcing will be most favorable when the MTF has reasonable support from key stakeholders.

j. Personnel Relocation

Does the personnel relocation plan sufficiently address the needs of in-house personnel affected by the outsourcing decision? If so, outsourcing will be favorable. When in-house personnel needs are addressed, outsourcing is more successful for the personnel and the MTF.

k. Transition Plan

Does the transition plan describe the process for the seamless transfer of service delivery from in-house to contract? Does the plan identify potential problems and procedures for resolving them? If so, outsourcing is favorable. If not, the transition plan needs modification or the service should be retained in-house.

l. Alternatives

Have viable alternatives to service delivery been sufficiently identified and evaluated? Can service delivery be achieved more cost effectively and efficiently by some alternative in-house method? If so, outsourcing is unfavorable. Is outsourcing the best alternative for service delivery? If so, outsourcing is favorable.

m. Convenience

The closer the commercial source, the less likely delays will occur in service delivery due to traffic congestion, road construction, flooding, or other natural disasters. Likewise, the more

convenient the patient's access to the service or treatment, the more likely the patient will utilize the service or treatment.

n. Measure Contractor Performance

To avoid disagreement in the PWS, the MTF and the contractor should mutually agree upon the key contract provisions. The contractor should have the opportunity to comment upon and influence the final PWS, as the contractor may have more experience in developing successful outsourcing contracts in their area of specialization.

Specific performance measures should be in place to quantitatively and qualitatively measure outputs and/or outcomes of both the in-house and contractor performance of the service. When the service is outsourced, this enables the MTF to determine whether contractor performance is better, as good as, or worse than the in-house staff capability. For example, if contractor costs rise and quality decreases below the minimal acceptable level, then contract modifications may be required to remedy the situation. In addition, a system should be in place to measure and record contractor performance. This enables measurement of performance over time and provides a source of reference if disagreements over performance arise.

The performance specifications should detail what (e.g., put food onto plates) the contractor should do without describing how (e.g., place spoon in serving platter, scoop food onto spoon, then place food from the spoon onto the plate) the contractor should do it. This provides the contractor the flexibility to apply new technologies and best business practices to reengineer the support activity. The PWS

should encourage the contractor to adopt new ways of doing business to reduce costs, increase efficiency, and improve quality of service delivery.

Finally, the PWS should include incentives for continuously improved performance and penalties for poor performance. Incentives may include a bonus or a share of the cost savings realized for achieving a certain level of performance within a pre-determined time frame. Conversely, penalties include payments by the contractor or reduced payments to the contractor for failure to achieve prescribed performance levels within a certain time frame.

o. Contractor Selection

Source selection is an important aspect of contracting out services. Part of the source selection process is to screen out unqualified bidders. This entails development of a clearly defined PWS that outlines the scope of the work to be performed. Combined with the contract, these documents spell out the responsibilities of each party.

A source selection includes a best value approach that establishes clear criteria to evaluate contractor capabilities. Quality and performance criteria are the preferred criteria to use when contracting. Another approach for selecting a contractor is to evaluate the MTF's previous and existing relationship with the contractor.

To begin this process, it is necessary to select potential contractors and review their business approaches. Next, an outline of characteristics deemed essential to an outsourcing relationship and that addresses the complexity level of the activity being outsourced is needed. The MTF Commander, Contracting Officer, and functional expert

must also consider all factors, from service delivery processes through managing the conversion to contract. After this, potential contractors should be solicited to come up with proposals. The next step is to open negotiations by outlining MTF needs to potential contractors. This includes providing data on projections for the next five years to compare recurring costs with the projected costs of the contractor. When this review is completed, the MTF should select the contractor that meets the criteria of responsiveness, flexibility, efficiency, professionalism, and team work orientation.

p. Contractor Management

There are a variety of ways to manage contractors. Regardless of the method used, establishing open communications and good working relationships are important aspects of successful outsourcing. Communication between the MTF and the contractor are critical if MTF and contractor outsourcing plans and service level commitments are to be agreed upon. Care to confirm that the contractor will submit reports regularly to ensure effective, efficient, and economical service delivery is important. This ensures that control remains with the MTF. In addition, make sure the contractor understands MTF objectives so appropriate resources will be used to deliver the service.

It is equally important to establish a good working relationship with contractor employees. This can be accomplished by introducing contractors and their employees to the MTF, allowing them to become familiar with MTF operations, and acquainting them with in-house personnel. If the service will be performed at the contractor site, the contractor should assign a point of contact to the MTF to manage issues

and enhance communication. If contract personnel will perform the service at the MTF, the contractor must provide an on-site supervisor to manage personnel issues.

Finally, if contractors change, they must be managed differently, requiring different management skills. It will also be necessary to establish open communications and a good working relationship with the new contractor to facilitate successful outsourcing.

q. Train a Contract Oversight Team

Successful outsourcing requires a trained team of functional experts and contract administrators who can communicate effectively with contract personnel on a daily basis. This team should be co-located with the contractor at the in-house or contractor site. Having a well-trained oversight team in place contributes to an overall successful outsourcing experience. While training costs may not be insignificant, ability to effectively write the contract and monitor the contractor may compensate for these costs through reduced contract modification and contract dispute costs in the long run.

r. The Contract

An important element of outsourcing is the service contract. The contract defines the quality, timeliness, and economy of the services that are expected. If confidentiality is a concern, this should be written into the contract. Furthermore, goals should be established, and measures should be outlined so both parties come to a mutual understanding of the type and level of service that is expected. These elements should be specified in detail. While it is necessary to

be as specific as possible in stating the service to be performed, how it is to be performed, who will perform it, and when, it is equally necessary to include flexible contract terms to enable the contractor to perform the service and to allow minor adjustments to be made to the contract without the MTF incurring large fees for the changes.

3. What Variables Should Be Used to Evaluate the Make-or-Buy Decision?

Variables to consider for successful outsourcing include the costs, quality of providing the service, projected savings, and use of outside experts.

a. Costs

The basis for all costs considered in government cost analyses is the MEO. Based on the PWS, the MEO refers to the government in-house mix of federal employee and contract support requirements for performing a commercially available activity in-house. The MEO is the product of the management plan, a plan that outlines organizational changes that will result in the MEO to perform an activity in-house by the government. This document provides staffing patterns and operating procedures that serve as a baseline for in-house costs.

Once the MEO is completed, the cost comparison may be initiated. At minimum, MTF Commanders should approach the comptroller and functional expert to prepare data used in the make-or-buy analysis. The cost comparison should measure the in-house cost of inputs consumed to provide outputs and/or outcomes of the service. Focus on variable costs, avoidable and incremental costs, and opportunity costs. Variable costs are those that increase or decrease proportionally to changes in

the volume of service. Avoidable costs are the costs that can be avoided by the decision. For instance, in making the decision to make, initial contract conversion and recurring contract monitoring costs are avoided. Opportunity cost results from consuming resources for one service that could have been used to for another service. It is the cost of the next best use of those resources. In addition, when costs occur over a period of more than one year, the make-or-buy analysis should account for costs effected by inflation using guidance provided annually in the President's Budget.

It must be kept in mind that costs relevant to one decision may be more or less relevant in another decision. For example, food server labor costs are relevant to the decision to outsource food service but these costs are not relevant to the decision to outsource laundry service and should not be included in this decision.

An approach for identifying and measuring costs is to figure out the physical outputs, such as number of meals served per day, then figure out the inputs (i.e., labor, equipment, and capital) needed to produce those outputs, or number of meals. Costs are then assigned to each of the inputs and summed to identify the cost of performing the service. The next step is to identify incremental costs. These are the costs that change as a result of the outsourcing decision, such as in-house labor costs. These are among the relevant costs evaluated to make the outsourcing decision. This data is compared to contractor cost estimates to determine whether service delivery costs less to perform in-house or by contract.

Another approach is to identify outcomes. This is achieved by conducting surveys of personnel, patients, and visitors who benefit from the service, such as food service. The survey can be used to determine customer satisfaction, identify consumer preferences and complaints, and obtain an overview of demands for service relative to the current level of service. This information can then be used to determine the inputs the MTF will use to measure costs. The next step is to trace the inputs and resulting costs to perform the determined level of service.

When the cost comparison is completed, the next step is to compare MTF cost estimates against the sum of the contractor cost estimate, contract administration costs, and one-time contract conversion costs. It must be recalled that OMB Circular A-76 requires a threshold differential of 10% of personnel costs or \$10 million dollars over the performance period for outsourcing to be considered. Therefore, if this criterion is met, then the service should be outsourced.

b. Savings

Cost savings are not calculated as the difference between the in-house and contractor cost estimates. Rather, cost savings are calculated as the sum of avoidable and incremental costs. If the savings from outsourcing are significant, such as more than 10% of in-house personnel costs or \$10 million dollars over the performance period, then outsourcing is the favorable alternative.

c. Quality

The MTF Commander should have a clear understanding and measurability of the type and level of service being performed by the in-house or current contractor. In addition, the MTF Commander should develop a clear understanding of the minimum type and level of service that will be acceptable for the function when provided in the future.

Quality standards that meet federal, health care, and other guidelines for the service in hospitals can be readily determined from instructions and regulations. The difficulty in quality measurement stems from quality factors, such as responsiveness of food servers to customer requests, that go beyond these baseline measures.

To facilitate the quality measurement process, it is necessary to develop a QASP to describe the quality level provided by the current method of service delivery, and how it will differ if services are converted from or to in-house or contractor performance. If quality will differ as a result of conversion from or to in-house or contractor delivery, the reasons must be explained. The QASP also describes the method of quality inspection to be used to evaluate service delivery. The concept is to develop a baseline against which contractor performance will be measured. Although the QASP is not included in the bidding process, its content may be incorporated into the PWS that in-house and potential contractors will use to develop bids.

Quality of service may be measured by the number of complaints received or by surveys of personnel, patients, and visitors who benefit from the service, such as food service. Complaints and

surveys can be used to assess customer satisfaction, identify consumer preferences, and obtain an overview of demands for the service. This information will help the MTF Commander determine the acceptable quality level the MTF will use to measure contractor quality. The next step is to trace the inputs and resulting costs to deliver service at this quality level. Input and cost identification can then be used to develop the quality measurements for the contractor to meet or exceed.

Having quality measurements provides a benchmark to compare contractor quality of service. The general expectation is that outsourcing will result in equal or higher quality than currently provided. Therefore, an increase in quality of service provided by the contractor favors outsourcing.

d. Outside Experts

When measures of cost, quality, and performance are more complex to define, it may be prudent to hire outside experts to provide an impartial audit of MTF resource requirements, costs, and management of support activities. However, the benefits to be gained from this information should outweigh the cost to get it.

4. Making the Decision

After all the relevant criteria and variables have been evaluated, it is time to make the decision to provide the service in-house or by contract. When the criteria and variables used to evaluate the decision favor outsourcing, then the service should be contracted out. Otherwise, the service should be retained in-house.

C. RECOMMENDATIONS

Naval hospitals should perform services in-house when the criteria and variables used to evaluate and form the make-or-buy decision dictate in-house performance. Conversely, when evaluation of the criteria and variables favor outsourcing, then the MTF should contract out the service. This occurs when the benefits outweigh the costs of outsourcing. Specifically, BUMED hospitals should outsource when:

- The MTF resources can be focused on activities directly associated with mission accomplishment.
- Internal resources can be redirected toward operational readiness.
- Patient access or outcomes will be improved.
- Contractor service delivery will result in ability to stay within or under FTE limits.
- Costs are measurable and service delivery will be more cost effective.
- Quality of service delivery is measurable and will be equal to or higher than that provided by in-house performance.
- Changes in service volumes will be matched by the contractor.
- The MTF and contractor cultures are amenable to the outsourcing arrangement.
- Stakeholder response to the outsourcing initiative is supportive.
- The majority of in-house personnel can be relocated.
- Transfer of the service from in-house to contractor performance will be as seamless as possible.
- The outsourcing alternative is more favorable than other alternatives, applying all criteria for evaluation.

- Contractor service delivery will be as convenient for MTF personnel and patients as in-house service delivery.
- Contractor performance is measurable and performance measure records can be maintained.
- Selection of a responsive, flexible, professional, and team work oriented contractor is possible.
- A contractor management system is in place to facilitate the relationship between the MTF and contract personnel.
- A contract oversight team is trained and in place to monitor the contract.
- The contract appropriately defines the quality, timeliness, and price of the service expected.

This case focus research was narrow because so few services have been contracted out by MTFs as commercial activities. Therefore, an additional suggestion is that MTF Commanders should contact BUMED to collect information from the Outsourcing Support Office or interview other federal agencies to identify other activities for outsourcing. These points of contact can also provide helpful information on how other services have been successfully outsourced.

D. QUESTIONS FOR FURTHER RESEARCH

- What other commercial activities should BUMED contract out?
- What are the costs to conduct make-or-buy analyses?
- What are the methodologies and costs to measure contractor performance?
- What are the costs used to monitor outsourced service delivery?
- When should DoD hospitals contract out under managed care?

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